

Before the

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

SBC COMMUNICATIONS INC.,
SBC DELAWARE INC.,
AMERITECH CORPORATION,
ILLINOIS BELL TELEPHONE COMPANY
d/b/a AMERITECH ILLINOIS, and
AMERITECH ILLINOIS METRO, INC.

Joint Application for approval of the
reorganization of Illinois Bell Telephone
Company d/b/a Ameritech Illinois, and the
reorganization of Ameritech Illinois Metro,
Inc. in accordance with Section 7-204 of
The Public Utilities Act and for all other
appropriate relief.

Docket 98-0555

Rebuttal Testimony
of

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on behalf of the

Government and Consumer Intervenors (GCI):

Citizens Utility Board
Cook County State's Attorney
Attorney General of the State of Illinois

December 18, 1998

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REBUTTAL TESTIMONY

Introduction

Q. Please state your name, position, and business address.

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc., One Washington Mall, Boston, Massachusetts 02108.

Q. Dr. Selwyn, have you previously submitted testimony in this proceeding?

A. Yes. On October 28, 1998, I submitted direct testimony in this proceeding on behalf of the Government and Consumer Intervenors (GCI), consisting of the Citizens Utility Board, the Cook County State's Attorney, and the Attorney General of the State of Illinois.

Summary of testimony

Q. Please summarize your rebuttal testimony.

A. In my direct testimony, I discussed at great length the numerous risks to Illinois consumers and competing local exchange carriers seeking to enter the local exchange market that are engendered by the proposed merger between SBC and Ameritech (Applicants). This rebuttal testimony will address and refute the contentions raised by SBC witness James S. Kahan, Ameritech witness David H. Gebhardt, SBC/Ameritech

1 witness Robert G. Harris, and certain aspects of the testimony of Staff witness Rasha
2 Yow, on the following issues:

- 3
4 • *Only minimal, primarily niche-market competition currently exists in the local service*
5 *market in Illinois:* There is currently no mass-scale competition in the Illinois local
6 service market, and the incumbent LEC, Illinois Bell, continues to maintain a market
7 share in the 99% range.
8
- 9 • *Approval of the merger will have a chilling effect upon the entry of new local*
10 *competitors into Illinois and other portions of Ameritech's serving area:* The
11 increased concentration and elimination of SBC as an important and highly qualified
12 actual potential competitor will work to strengthen the post-merger SBC/Ameritech's
13 dominance in the Illinois telecommunications market and have a significant adverse
14 impact upon the development of actual and effective competition.
15
- 16 • *SBC is an actual potential competitor in the Ameritech region, and particularly in*
17 *Illinois:* SBC had begun to pursue a large-scale local wireline service entry initiative
18 in the Chicago metropolitan area bootstrapped off of its extensive cellular operations,
19 but abruptly abandoned this plan when its out-of-region entry strategy changed from
20 competition to acquisition.
21
- 22 • *The Applicants' National-Local Strategy will have an adverse impact upon Illinois*
23 *Bell and customers of its noncompetitive services:* SBC's plans to staff and finance
24 its new out-of-region entry program will divert resources from Illinois Bell and other

1 SBC ILECs and will be cross-subsidized by captive customers of the Company's
2 noncompetitive services.

- 3
- 4 • *Section 7-204(c) of the Illinois Public Utilities Act applies to all Illinois utilities,*
5 *including those currently operating under an alternative form of regulation:* There is
6 no factual basis for the Applicants' contention that Section 7-204(c) does not apply
7 to "price cap" regulated companies such as Illinois Bell.
8
 - 9 • *The amount of merger-related synergy benefits that should be shared with Illinois*
10 *Bell ratepayers is correctly based upon the size of the premium that SBC is to pay to*
11 *acquire Ameritech in this arm's length transaction between two highly sophisticated*
12 *and knowledgeable entities.*
13

14 **The local service market in Illinois is not effectively competitive at the present time.**
15

16 Q. Dr. Selwyn, Mr. Kahan claims that your testimony should be disregarded because, he
17 contends, it mischaracterizes the state of local competition in Illinois by failing to
18 acknowledge the existence of AT&T and MCI as competitors.¹ Do AT&T and MCI
19 represent broad-based competition for Illinois Bell's local telephone services?
20

21 A. No, they do not. In his rebuttal testimony, Mr. Kahan discusses at length the emergence
22 of competitors, particularly large "integrated" interexchange carriers such as AT&T, MCI
23 and Sprint, into the Illinois local market, yet appears to rely simply upon their existence

24 1. Kahan (SBC), Rebuttal at 4-7, 66.

1 in the marketplace as some sort of proof of the "success" achieved by these companies in
2 presenting a serious challenge to Illinois Bell's incumbency, monopoly and dominance.²

3 In fact, Mr. Kahan relies heavily upon the presumption that the extensive advertising and
4 marketing of integrated services by these three IXC's is somehow linked to the current
5 level of market share possessed by each.³

6
7 Mr. Kahan's characterization of the current condition of the local service market is in
8 stark contrast to SBC's view that true mass-scale local entry can only take place if it is
9 permitted to acquire Ameritech and thereby to launch its so-called "National-Local
10 Strategy." Indeed, Mr. Kahan has repeatedly emphasized the importance of the proposed
11 merger to the success of the National-Local Strategy.⁴ Among other things, Mr. Kahan
12 testified that local entry could not succeed unless pursued on a mass scale,⁵ and that
13 some 8,000 employees and experienced management personnel, drawn from both SBC
14 and Ameritech local telephone operating companies, would be essential if the effort was
15 going to be successful.⁶

16
17 By Mr. Kahan's own standard, then, neither AT&T nor MCI can expect to be successful
18 in competing with ILECs *on a mass scale*. Neither AT&T nor MCI possess a large pool

19 2. *Id.*, at 6.

20 3. *Id.*, at 20, 52-56, 66, 73-74, 81-84 and 91.

21 4. Kahan (SBC), Direct at 6-7; Rebuttal at 56-59; FCC Affidavit at ¶ 11.

22 5. Kahan (SBC), FCC Affidavit at ¶ 11.

23 6. Kahan (SBC), Rebuttal at 57, 59.

1 of management or craft talent experienced in the provision of local services; AT&T lost
2 those people at the time of the break-up of the former Bell System, and MCI never had
3 them to begin with. If SBC could not, by its own admission, amass the needed local
4 service management resources without acquiring another RBOC, how can anyone expect
5 entities such as AT&T and MCI, without these resources, to represent a serious
6 competitive threat in the local service market?

7
8 In fact, and as I discussed at pages 39-43 of my direct testimony, the level of actual
9 competition in the serving areas of both Ameritech and SBC is minimal at this time and
10 is anything but broad-based. In Table 1 of his rebuttal testimony, Mr. Kahan provides
11 statistics that purport to prove the existence of substantial market entry on behalf of
12 CLECs,⁷ yet his data is extremely misleading and grossly exaggerates the actual extent
13 of competitive presence in SBC's serving areas. Based upon the data in Table 1, SBC
14 has lost no more than 3.6% of the 33.4-million access lines in its 7-state region, and
15 2.1% out of that 3.6% are in fact still being provided by SBC on a resold basis.⁸ Thus,
16 while there may be limited competition at the *retail* end of the local service market, SBC
17 remains solidly in control of over 98% of the underlying local service facilities.⁹ As I

18 7. Table 1, on page 90 of Mr. Kahan's rebuttal testimony, apparently is an updated version
19 of Table 3 from Mr. Kahan's direct testimony.

20 8. According to Table 1, 1,194,322 of a possible 33,440,000 lines in SBC's 7-state region
21 have been lost to CLECs. Kahan (SBC), Rebuttal at 90; Statistics of Communications
22 Common Carriers, Table 1.1, 1997 edition.

23 9. In Table 2 at page 91 of his rebuttal testimony, Mr. Kahan attempts to estimate the
24 number of lines provided by CLECs through interconnection trunks, yet he provides no
25 support whatsoever for his estimate of 2.75 lines per trunk, and also fails to acknowledge why
26 at least some, perhaps even the majority, of these lines would not be included in the E-911

27 (continued...)

1 noted in my direct testimony at page 39, only a monopolist would characterize the retail
2 sale of its own products and services by non-affiliated resellers as "competitive losses."

3
4 Mr. Kahan cites the amount of CLEC advertising as "compelling evidence" that CLECs
5 are competing with SBC in the 7-state region.¹⁰ His conception of the extent of IXC
6 local service competition thus appears to come from watching their commercials on TV
7 or reading their ads in local newspapers, but the level of CLEC advertising teaches
8 nothing about the actual level of CLEC penetration or local service market share. What
9 is at issue in this case is not the level of CLEC advertising, but rather the level of actual
10 CLEC competition for ILEC local services. The fact that *all* competitors, from the giant
11 IXCs down to the smallest niche-market players, are only capable of capturing just 1.5%
12 of the total market for lines served in SBC's 7-state region,¹¹ despite the substantial
13 CLEC marketing efforts described by Mr. Kahan, is compelling evidence indeed that the
14 market for local service is far from exhibiting the characteristics of effective competition,
15 regardless of the presence of large national companies like AT&T and MCI.

17 9. (...continued)
18 listings; therefore, this analysis should be disregarded. However, even if we consider Mr.
19 Kahan's estimates in Table 2 to be correct and non-duplicative of Table 1, this still leaves
20 SBC with control of 96.7% of the local service market. This value is calculated by dividing
21 the number of "bypass lines" by the total number of lines in SBC's territory (SBC lines plus
22 the total number of CLEC bypass lines).

23 10. Kahan (SBC), Rebuttal at 91.

24 11. Even if we assume Mr. Kahan's estimation of "bypass" lines is correct, CLECs still
25 control just 3.3% of the local service market.

1 Q. Do the Applicants and other ILECs have an incentive to overstate the extent of
2 competition they actually confront for their core local services?
3

4 A. Indeed, they do. Besides the obvious benefit of convincing regulators, in the present
5 context, that robust competition is sufficiently established that it cannot be harmed by the
6 proposed merger, Illinois Bell can realize significant financial benefits if it can convince
7 regulators that noncompetitive services are "competitive."
8

9 Q. Please explain.
10

11 A. Under the price cap form of regulation adopted by this Commission in Docket
12 92-0448/93-0239 (consol.), prices for "noncompetitive" services are subject to strict limits
13 as determined by the annual change in the Gross Domestic Product Price Index (GDP-PI)
14 offset by a productivity or "X" factor of 4.3%¹² (plus or minus certain so-called
15 "exogenous" cost changes). Because the annual change in GDP-PI has generally been
16 lower than 4.3% in each of the years since the implementation of price caps in Illinois,
17 the Company has actually been required to *reduce prices* for its monopoly basic services
18 since the onset of price caps in 1994.¹³ However, the Illinois price cap system provides

19 12. ICC Docket No. 92-0448; 93-0239 Consol., *Illinois Bell Telephone Company: Petition*
20 *to Regulate Rates and Charges of Noncompetitive Services Under An Alternative Form of*
21 *Regulation. Citizens Utility Board -vs- Illinois Bell Telephone Company: Complaint for an*
22 *investigation and reduction of Illinois Bell Telephone Company's rates under Article IX of the*
23 *Public Utilities Act*, Order, at 40.

24 13. ICC Docket No. 95-0182 Order, June 21, 1995; Docket No. 96-0172 Order, June 26,
25 1996; ICC Docket No. 97-0157 Order, June, 1997; and ICC Docket No. 98-0259 Order, June
26 30, 1998.

1 a mechanism for "reclassification" of individual services to "competitive" status if certain
2 conditions are satisfied. Specifically, Section 13-502(b) of the PUA states that:

3
4 A service shall be classified as competitive only if, and only to the extent that, for
5 some identifiable class or group of customers in an exchange, group of exchanges, or
6 some other clearly defined geographical area, such service, or its functional
7 equivalent, or a substitute service, is reasonably available from more than one
8 provider, whether or not any such provider is a telecommunications carrier subject to
9 regulation under this Act. (220 ILCS 5/13-502(b)).
10

11 In its Order in Dockets 95-0135/95-0197, Consolidated, the Commission stated that in
12 making a decision in a reclassification proceeding under Section 13-502(b), the
13 Commission would consider three basic issues:
14

- 15 (1) The functional equivalence of alternative services; or
16 (2) the substitutability of alternative services; and
17 (3) the reasonable availability of those functional equivalent or substitute services.
18

19 Once a service is reclassified into the "competitive" category, it is no longer subject to a
20 price cap and the Company is free to adjust (raise or lower) the prices of such services as
21 it wishes, with the sole constraint being the Long Run Service Incremental Cost (LRSIC)
22 as the "floor" price. In principle, if a service is subject to actual competition, consumers
23 would be protected against price hikes by competitive marketplace forces. However, this
24 has not occurred in actual practice.
25

26 Q. Please explain.
27

1 A. A report issued November 25, 1998 by the Commission's Telecommunications Division
2 Staff¹⁴ highlights the problem: "Between March of 1997 and November of 1998,
3 Ameritech Illinois filed twelve tariff filings in which it reclassified several of its business
4 and residential services as competitive."¹⁵ These were all in the form of tariff filings
5 made on one day's notice, and were permitted to go into effect. As the Staff Report
6 notes, "[a]fter declaring some of the services listed above as competitive, Ameritech
7 increased the retail and wholesale rates for those services."¹⁶ In some cases, *the prices*
8 *of services that were already set well in excess of cost*, such as local usage, were
9 increased.

10
11 Q. Can anything be inferred from these reclassifications and subsequent rate increases as to
12 the presence of competition for these services?

13
14 A. Indeed, yes. In its Order in Docket 95-0135/0179 in which the Commission rejected
15 Illinois Bell's reclassifications to "competitive" of Band B calls, Band C calls, credit card
16 calls, and operator assistance services, the Commission stated:

17
18 Competitive classification under Section 13-502 requires a convincing demonstration
19 that competition will in fact serve effectively as a market-regulator of the quality,
20 variety and price of telecommunications services. *Ameritech Illinois' ability to*
21 *increase its prices notwithstanding the presence of other providers is a strong*
22 *indication that those rates are not just and reasonable, and that the competitive*

23 14. Telecommunications Division, Illinois Commerce Commission, *Staff Report on*
24 *Competitive Reclassification*, issued November 25, 1998.

25 15. *Id.*, at 5.

26 16. *Id.*, at 10.

1 *classification here fails to satisfy this statutory policy.* The evidence indicates rather
2 that the declaration of competition in this case is being used as a device to raise rates
3 to customers which demonstrably have not found the alternative offerings by other
4 carriers to be the functional equivalents or reasonably available substitutes for
5 Ameritech Illinois' service.¹⁷
6

7 As the Staff Report goes on to observe, in affirmation of the Commission's rejection of
8 these reclassifications, the Illinois Appellate Court found that:

9
10 Allowing a provider to classify a service as competitive prior to the development of
11 a competitive market for the service would enable the provider to enjoy the benefits
12 of a monopoly without the concomitant regulation which the legislature has declared
13 is necessary to protect the interests of consumers. Accordingly, the Commission's
14 conclusion that it must examine actual market behavior in order to determine whether
15 a competing services is reasonably available was not clearly erroneous, and we defer
16 to this interpretation.¹⁸
17

18 A copy of the *Staff Report on Service Reclassification* is attached to my rebuttal
19 testimony as Appendix 1.
20

21 Q. Should the Commission accept Mr. Kahan's and Dr. Harris' assertions in this merger
22 proceeding as to the presence of competition in protecting consumers against the
23 anticompetitive effects of the increased concentration that this proposed merger would
24 create?
25

26 A. No, it should not. In fact, as the *Staff Report* also notes, for each of the various
27 competitive reclassification filings,

28 17. Quoted in *Staff Report*, at 3. Emphasis supplied.

29 18. *Id.*, at 5.

1 in the support material accompanying the reclassification of the services listed [in the
2 Staff Report], it is questionable whether Ameritech Illinois provided sufficient
3 evidence to demonstrate that these services are competitive. Specifically, Ameritech
4 provided a one or two page verified statement for each filing, listing possible
5 competitors for the services in its filings. However, *Ameritech did not provide any*
6 *information regarding its market share for each reclassified service; the trend of its*
7 *market share for the reclassified service; specific examples of services that compete*
8 *with Ameritech's service; whether there are any functional differences in the*
9 *Ameritech's service and that of a competitor, an explanation of the functional*
10 *differences between those services to the extent they exist; or an analysis of the*
11 *impact on demand of any price increase associated with the reclassification.*¹⁹
12

13 The various claims as to the presence of competition in the Illinois local service market
14 that have been offered by the Applicants in the present proceeding suffer from precisely
15 these same deficiencies. The Commission has no more basis to accept Mr. Kahan's and
16 Dr. Harris' contentions, based entirely upon sightings of would-be rivals, than it did with
17 respect to claims as to the conformance of the various services that Illinois Bell has
18 sought to reclassify as "competitive" with the statutory and regulatory standards.
19

20 Following the release of the Staff Report, the Commission on November 30, 1998 issued
21 Orders initiating two new dockets specifically for the purpose of examining these recent
22 Illinois Bell service reclassifications.²⁰ In Docket 98-0860, the Commission will
23 consider "whether the classification as competitive of the services provided by Illinois
24 Bell Telephone Company pursuant to the tariffs listed in the Appendix to this order is

25 19. *Id.*, at 10. Emphasis supplied.

26 20. ICC Docket No. 98-0860, *Illinois Commerce Commission On Its Own Motion vs.*
27 *Illinois Bell Telephone Company, Investigation into Specified Competitive Tariffs to*
28 *Determine Proper Classification of the Tariffs and to Determine Whether Refunds Are*
29 *Appropriate*, and ICC Docket No. 98-0861, *Illinois Commerce Commission On Its Own*
30 *Motion vs. Illinois Bell Telephone Company, Establishment of Filing Requirements for the*
31 *Reclassification of Noncompetitive Services as Competitive Services.*

1 proper and to determine refunds for any retail services found to be not properly classified
2 as competitive, as well as their wholesale counterpart."²¹ In Docket 98-0861, the
3 Commission will "establish filing requirements for the reclassification by Illinois Bell
4 Telephone Company of noncompetitive services as competitive services pursuant to
5 Section 13-502 of the Public Utilities Act."²²

6
7 In view of the initiation of these two investigations and the paucity of substantive
8 information supporting claims as to the competitive nature of its various services that
9 Illinois Bell has furnished to the Commission, and in view of the fact that the evidence
10 being offered by the Applicants herein contain essentially the same types of anecdotal
11 descriptions of would-be competitors as the Commission has in the past and has again
12 concluded are insufficient for a determination of the presence of actual competition, it is
13 difficult to see how the Commission can give any credence to the various claims being
14 advanced by the Applicants' witnesses here.

15
16 Q. In his rebuttal testimony, Mr. Gebhardt has data alleged to be proprietary regarding
17 Illinois Bell's share in the local service market,²³ although I understand that you
18 disagree with the basis for his calculation, which, like the analysis provided by Mr.
19 Kahan, treats resellers of Illinois Bell's services as "competitors" of the telephone
20 company. That notwithstanding, has this Commission previously made any findings as to

21 21. ICC Docket No. 98-0860 Order, at 2.

22 22. ICC Docket No. 98-0861 Order, at 2.

23 23. Gebhardt (Ameritech), Rebuttal at Schedule 2.

1 the relationship between Illinois Bell's market share and the determination that a "service,
2 or its functional equivalent, or a substitute service, is reasonably available from more
3 than one provider, whether or not any such provider is a telecommunications carrier
4 subject to regulation under this Act"²⁴?

5
6 A. Yes. The Staff Report notes that in its Order in Docket 95-0135/0179 dealing with
7 reclassification of Band B and C calls, "because Ameritech held 86.6% of the market
8 share, the Commission found that the IXC's services were not reasonably available to
9 Ameritech's customers."²⁵ Significantly, the Commission concluded that an 86.6%
10 market share on the part of Illinois Bell was evidence of a *lack* of competition, and on
11 that basis specifically *rejected* the Company's reclassification of these services as
12 "competitive." Even if Mr. Gebhardt's computation of the Illinois Bell local service
13 market share were valid, which as I have explained it is not,²⁶ by his own reckoning the
14 Company has a share of the local service market *well in excess of the level of market*
15 *dominance that this Commission has previously found to evidence a lack of effective*
16 *competition.*

18 24. 220 ILCS 5/13-502(b).

19 25. *Staff Report*, at 4.

20 26. In addition to Mr. Gebhardt's treatment of resellers, he, like Mr. Kahan, attempts to
21 estimate the number of self-supplied CLEC lines without providing any supporting
22 documentation while, in his case alone, providing no explanation of the methodology used to
23 make these estimates. Therefore, Mr. Gebhardt's assessment of the extent of competition in
24 the Illinois local market should also be disregarded.

1 **Approval of the merger will in no way enhance, and will likely adversely affect, the level**
2 **of competition in Illinois and other portions of Ameritech's serving area**
3

4 Q. Dr. Selwyn, the Applicants contend that, in order to compete in the telecommunications
5 market, it is necessary to become an "integrated" provider of service with a national
6 presence, much like AT&T, MCI and Sprint.²⁷ Will the merger create an "integrated"
7 provider of service with a national presence, much like AT&T, MCI and Sprint?
8

9 A. The merger *per se* will not make SBC/Ameritech into an "integrated" local/long distance
10 provider; the two companies can, individually, achieve that status by complying fully
11 with Section 271 of the federal *Telecommunications Act*. The theory underlying Section
12 271 is that the BOCs would be unable to leverage their local monopoly to dominate the
13 long distance business if there were actual and effective competition in the local
14 exchange market, and the Section 271(c)(2)(B) "competitive checklist" was designed to
15 make local entry possible by requiring that the BOCs eliminate specific economic barriers
16 to such entry. That no BOC has as yet, nearly three years after enactment of the federal
17 statute, satisfied the Section 271 requirement confirms the utter lack of effective local
18 competition that presently exists here and throughout the country.
19

20 Significantly, SBC's National-Local Strategy contemplates precisely the kind of leverage
21 of the local monopoly into adjacent competitive markets that the federal *Act* was
22 attempting to eliminate. SBC candidly states that it plans to, and expects that it can,
23 readily capitalize upon its relationship with the various large corporate customers

24 27. Kahan (SBC), Rebuttal at 6-7, 48-49.

1 headquartered within the 13-state post-merger SBC region to encourage them to do
2 business with SBC in the 30 out-of-region local markets that it plans to enter and in the
3 long distance business, assuming that (at some point) SBC is able to gain Section 271
4 approval. For example, SBC could offer such customers volume purchase contracts that
5 include both the in-region monopoly local services as well as out-of-region local services
6 and long distance services. *No other telecommunications company, local or long*
7 *distance, would possess this capability.*

8
9 Q. Are you suggesting that it will be easier for Ameritech and SBC to vie for the long
10 distance business of in-region customers, once they obtain Section 271 authority, than for
11 IXCs to overcome the dominance of the ILECs in their respective in-region local
12 exchange markets, if (as the FCC has noted²⁸) compliance with the Telecommunications
13 Act of 1996 does not in and of itself ensure that barriers to CLEC entry are fully
14 removed and a competitive market effectively established?

15
16 A. Yes, precisely. SBC/Ameritech's entry into the long distance market could occur rapidly
17 after Section 271 approval. The mega-RBOC could purchase long distance services for
18 resale to its in-region local customers from any number of interexchange service
19 providers as well as by deploying its own (currently "official") interLATA transport

20 28. *In the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation,*
21 *Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, File
22 No. NSD-L-96-10, Memorandum Opinion and Order, released August 14, 1997 (*BA/NYNEX*
23 *Merger Order*) at ¶ 42.

1 facilities²⁹ for use in furnishing retail long distance services. A customer could be
2 switched to SBC/Ameritech long distance through a simple data base entry. (IXCs are
3 typically charged about \$5 for each such "PIC change," but have contended that the
4 actual cost is considerably less.³⁰) By contrast, considerable cost, time and effort are
5 required for a CLEC to switch a BOC local service customer to its own facilities-based
6 or UNE-based service; In Illinois, for example, Illinois Bell imposes nonrecurring charges
7 amounting to some \$38.25 for a CLEC to convert an existing Illinois Bell residence
8 customer to a UNE-based service.³¹ Moreover, because such conversions frequently
9 result in various "fallout" conditions (due to errors in order processing, data bases, or
10 other problems), such conversions can often result in inconvenience to the customer
11 including, for example, a temporary loss of dial tone. It will take a number of years
12 before the changeover of a BOC customer to a CLEC can be accomplished as quickly,
13 inexpensively, and seamlessly as a change in long distance provider.

15 29. In an exception to the interLATA line-of-business restriction, the RBOCs were
16 permitted, at the time of the break-up of the former Bell System, to construct and to own
17 interLATA facilities whose use was limited solely to intracompany communications (so-called
18 "official" services). *U.S. v. AT&T*, Civil Action No. 82-0192; (D.D.C., 1983), July 8, 1983,
19 as amended July 28, 1983, and August 5, 1983, 569 F. Supp. 1057, 1097-1101.

20 30. See December 16, 1996 Complaint filed by MCI, *MCI Telecommunications Corp. v.*
21 *US West Communications, Inc.*, citing a BellSouth PIC change cost study dated April 2, 1990,
22 that identifies the cost of a PIC change at \$1.49, averaged across all BellSouth territories.
23 Further, BellSouth's current interstate access tariff levies a rate of \$1.49 per line for an
24 Interexchange Carrier Subscription Change. BellSouth Telecommunications, Inc., Tariff
25 F.C.C. No. 1, Section 13.3.3.E.3, 7th Revised Page 13-12, effective January 25, 1997.

26 31. Illinois Bell Telephone Company, ILL. C.C. No. 20, Part 19, Section 2, 1st Revised
27 Sheet No. 8, effective April 18, 1998.

1 A graphic demonstration of the effect of this extreme disparity can be found in
2 Connecticut, where the dominant ILEC, SNET (now owned by SBC) is *not* required to
3 satisfy the Section 271 checklist in order for it to offer long distance services to its
4 customers,³² and has in fact been aggressively marketing these services to its local
5 service customers since 1993. SNET has been estimated to have captured some 38% of
6 Connecticut's presubscribed long distance lines,³³ while retaining more than 99% of its
7 core local service business.³⁴ Approval of the proposed merger, coupled with Section
8 271 authority throughout its expanded region, would allow SBC to replicate and surpass
9 the experience in Connecticut and thereby eradicate both local and long distance
10 competition across its entire 13 states.

11
12 Q. Mr. Kahan attempts to undermine the Applicants' competitors' opposition to the merger
13 as simply reflecting their "vested interest."³⁵ What is your view of Mr. Kahan's
14 contention?

15
16 A. As evidenced by my testimony and by comments filed by consumer groups in the FCC's
17 proceeding, Mr. Kahan's emphasis on competitors' opposition sidesteps the legitimate

18 32. Section 271 applies only to RBOCs; SNET is not an RBOC, and therefore was never
19 precluded from offering interLATA services.

20 33. Based upon the number of lines presubscribed to SNET America, Inc., as a percent of
21 total presubscribed lines in Connecticut using 1996 data. *Trends in Telephone Service*,
22 Industry Analysis Division, FCC Common Carrier Bureau, July, 1998, at Table 10.2 and 10.4.

23 34. UNE Loops account for just 0.13% of the total lines provided in SNET's service area.
24 Responses to the Second Common Carrier Bureau Survey on the State of Local Competition,
25 October 28, 1998, www.fcc.gov/ccb/local_competition/survey/responses (2nd Survey).

26 35. Kahan (SBC), Rebuttal at 56.

1 concerns that many parties (myself included) have expressed about the adverse
2 consequences of the merger for consumers and the public interest generally.

3
4 Q. Mr. Kahan and Dr. Harris claim that the merger will protect Illinois residential and small
5 business customers from future rate increases because the implementation of the
6 National-Local Strategy will allow the new SBC to compete with integrated carriers and
7 retain high-revenue (i.e., large business) customers.³⁶ Should residential and small
8 business customers take comfort from these assurances?

9
10 A. Hardly. Illinois Bell has a dismal track record with respect to rate increases imposed
11 upon its residential and small business customers, a point that was just underscored in the
12 report issued November 25, 1998 by the Commission's Telecommunications Division,
13 which I have previously discussed. Having declared various of its services to be
14 "competitive," Illinois Bell thereupon *increased* prices for many of these services. Mr.
15 Kahan's and Dr. Harris' rhetoric is belied by Illinois Bell's acts.

16
17 Large business customers may well generate substantial revenues: as stated by Mr.
18 Kahan, Ameritech receives 18% of its revenues from the largest 1% of its customers.³⁷
19 To the extent that there is actually greater competition in this segment than for residential
20 and small business customers, the Applicants' incentives would be precisely the opposite
21 of those portrayed by Kahan and Harris: If forced to sacrifice margins on large customer

22 36. Harris (SBC/Ameritech), Rebuttal at 30; Kahan (SBC), Rebuttal at 17-19.

23 37. Kahan (SBC), Rebuttal at 17.

1 accounts in order to retain their business, the post-merger SBC/Ameritech will have an
2 even greater incentive to shift revenues to the far more captive residential and small
3 business segment.

4
5 Moreover, even though the large customer segment may represent a substantial
6 component of revenue, this segment is also driving a perhaps even larger component of
7 the Companies' capital investments. Large corporate customers are demanding
8 sophisticated, high-technology telecom services, whereas the basic "dial tone" being
9 furnished to most residential and small business subscribers is barely different from what
10 they were receiving ten or fifteen years ago. Moreover, and unlike the technologically
11 and, in certain areas (such as Centrex), competitively volatile large business market, the
12 residential market is extremely stable, both in terms of the customer base and the
13 investment required to sustain the network for this segment. Even when a residential
14 premises changes hands, the basic residential dial tone access line typically remains in
15 place, virtually assuring the telephone company of recovery of its investment. By
16 contrast, if the ILEC deploys facilities with a capacity sufficient to serve a large Centrex
17 customer, it has no assurance that it will continue to furnish that service, which can be
18 replaced by a PBX requiring far fewer outside plant and central office switching
19 resources. Moreover, facilities-based competition is far more likely to arise in the large
20 customer segment than in the residential segment, imposing considerably greater risk for
21 the ILEC in pursuing and maintaining its large business customers than in continuing to
22 furnish services (either directly or via resale) to its core base of residential and small
23 business subscribers. Clearly, it is the small customer end of the market, and certainly

1 not the high-end corporate user, who is vulnerable to potentially large price increases if
2 SBC and Ameritech are permitted to do so.

3
4 Q. The Applicants' suggest that, following approval of the merger, their "success in serving
5 large corporate customers" in the 30 out-of-region markets will prompt other incumbents
6 to "retaliate" in a competitive manner, thereby increasing the level of competition in
7 Illinois.³⁸ Do you agree?

8
9 A. No, and even if some limited retaliatory entry were to occur, its impact upon the
10 residential and small business market would be minimal at best. As Mr. Kahan states,
11 Bell Atlantic and GTE, in their Public Interest Statement, have proposed to enter 21 out-
12 of-region markets.³⁹ Whether or not this plan can be considered a "retaliation" to
13 SBC/Ameritech's National-Local Strategy is debatable, since Bell Atlantic's plan
14 contemplates entry into just four markets within the current 5-state Ameritech footprint
15 (those being Chicago, Cleveland, Detroit and Indianapolis).⁴⁰ What's more important,
16 however, is the market targeted by these new competitors — which will be identical to
17 the target market for SBC/Ameritech in its out-of-region entry, namely the largest
18 business customers *who already experience the greatest level of competition in the local*

19 38. Kahan (SBC), Rebuttal at 23.

20 39. *In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation,*
21 *Transferee, For Consent to Transfer of Control*, CC Docket No. 98-184, Merger Application,
22 Public Interest Statement, at 6.

23 40. *Id.*

1 *service market*.⁴¹ There is no evidence that such "retaliatory" entry will have any
2 bearing upon the level of competition for residential and small business customers,
3 particularly since the Applicants have clearly expressed their intent to pursue the same
4 high-revenue customers that are the apparent target of the existing niche-market players.
5 It should also be remembered that, according to Mr. Kahan, SBC's projected level of
6 market penetration for its out-of-region forays is only 4%;⁴² there is no reason to expect
7 a Bell Atlantic/GTE "national local strategy" to be any more successful.

8
9 The Applicants have provided several "testimonials" by various large businesses who
10 support the merger,⁴³ further underscoring the Applicants' focus upon the high-end
11 corporate customer. One such firm, Ultramar Diamond Shamrock, sums up this point
12 succinctly when it states that "[the merger] will mean there is one *more* major
13 telecommunications company to compete for our business."⁴⁴ The Applicants'
14 suggestion that their pursuit of the National-Local Strategy will somehow impact the level
15 of competition for residential and small business customers in Illinois remains entirely
16 unsubstantiated. In fact, as discussed at length in my direct testimony, approval of this
17 merger may have the exact opposite effect upon local competition by (1) eliminating
18 some current competitors from the market, and (2) creating further barriers to entry for
19 new competitors, which could result in no new market entry whatsoever.

20 41. Kahan (SBC), FCC Affidavit, ¶ 40.

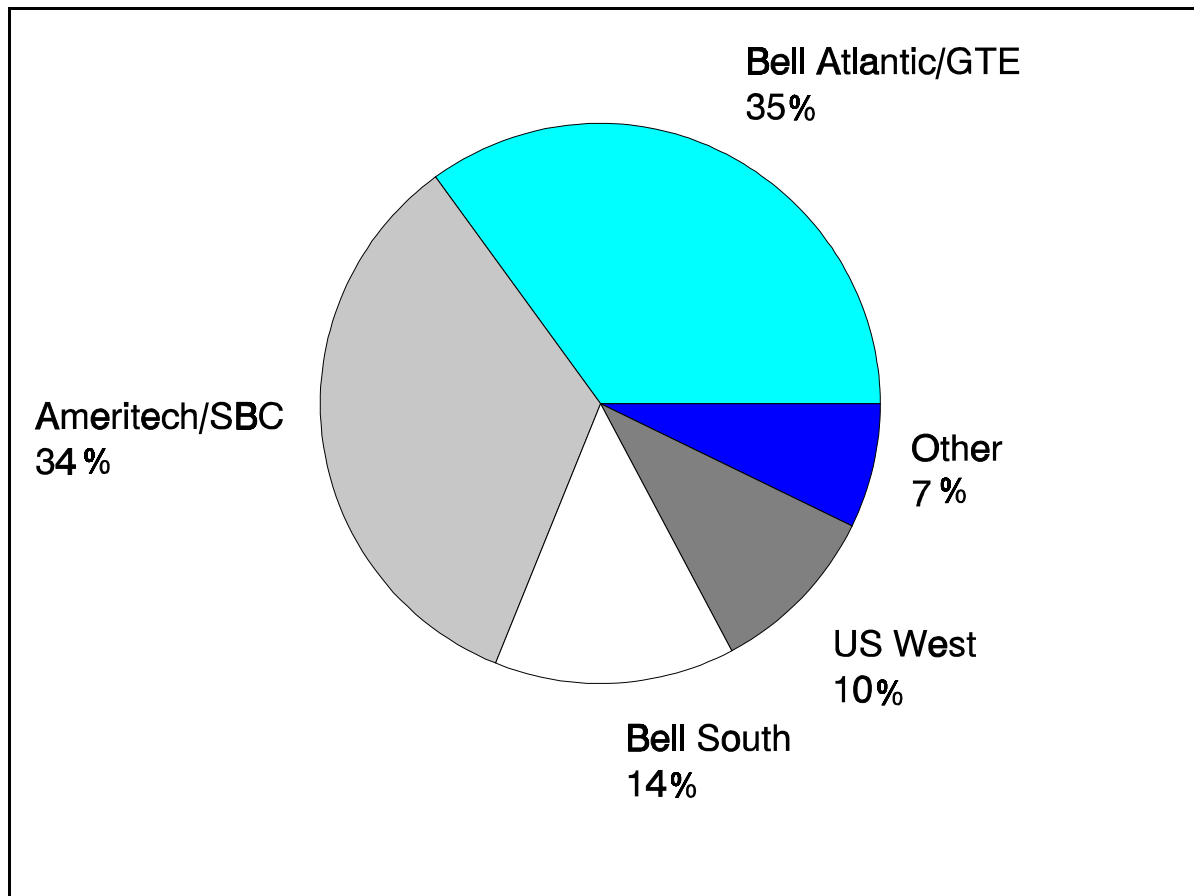
21 42. *Id.*, at ¶ 63.

22 43. Kahan (SBC), Rebuttal at 62-64; Attachments 7-14.

23 44. Kahan (SBC), Rebuttal at 64 and Attachment 10 (emphasis supplied).

1 Q. Can approval of this merger potentially result in less, rather than more, competitive entry
2 in the Illinois local service market?

3
4 A. Yes. If the SBC/Ameritech and Bell Atlantic/GTE mergers are permitted to go forward,
5 the two surviving mega-RBOCs will control 34% and 35%, respectively, of the local
6
7



ILEC Access Line Shares After Pending Mergers.

1 service market nationwide.⁴⁵ All of the other local telephone companies, including the
2 two remaining RBOCs — US West and BellSouth — as well as large Independents like
3 Cincinnati Bell, Frontier Communications, and Sprint, along with the remaining small
4 local telcos, will collectively control the remaining 31% of the US local service business.

5
6 A merger of the two remaining RBOCs, and even if some of the other Independent
7 ILECs are thrown in, would create an entity that is roughly the same size as the *pre-*
8 *merger SBC* is today, a size that Mr. Kahan and other SBC witnesses contend is simply
9 *too small* to pursue a mass-scale *de novo* local competition initiative. If Mr. Kahan's
10 assessment of the minimum viable scale for out-of-region local entry is to be believed,
11 then the *only* real potential non-niche competitor in the expanded 13-state SBC footprint
12 would be Bell Atlantic/GTE. And in view of the fact that for the past fifteen years, since
13 the 1984 break-up of the former Bell System, *none of the Baby Bells have competed with*
14 *each other for core wireline local services*, it is difficult to imagine, under the *duopoly*
15 condition that will prevail following the two currently-pending mergers, that these two
16 giants will really want to take each other on rather than remain comfortably within their
17 own home territories. The fact is that retaliatory out-of-region local entry is far more
18 likely to occur in an industry with less concentration and more players than in the post-
19 merger scenario being portrayed by the Applicants here.

20
21 45. Statistics of Communications Common Carriers, Table 2.10, 1997.

1 **SBC is one of the most likely, financially/technically capable, actual potential local**
2 **service competitors in the Ameritech region, and approval of the proposed merger would**
3 **eliminate this important source of potential entry.**
4

5 Q. Dr. Selwyn, Mr. Kahan states that, in his "layman's view of the [Illinois] statute," Section
6 7-204(b)(6) does not address the "future or potential harm" to future competition, and that
7 the provision applies solely to the effect of the merger upon *existing* competition.⁴⁶
8 Noting that aside from "the wireless properties that will have to be dealt with through
9 divestiture, Ameritech and SBC have absolutely no market overlap in Illinois. Base [sic]
10 on my reading of the statute, I believe the inquiry should end there."⁴⁷ Do you agree
11 with Mr. Kahan's "layman's" interpretation of Section 7-204(b)(6)?
12

13 A. No. Section 7-204(b)(6) was enacted by the Illinois legislature in 1997 in the context of
14 the existing minimal level of competition in the local telephone market. Extrapolating
15 from Mr. Kahan's logic, Section 7-204(b)(6) would be moot since, in addition to SBC
16 not being an actual competitor of Illinois Bell, which as I have discussed in my direct
17 testimony and as I shall discuss below it certainly is, there were (as of the date of
18 enactment) virtually no *other* serious competitors in the Illinois local service market
19 either. Hence, if the purpose of the statute was to be limited to the effect of a merger
20 upon existing competition, in the absence of any such competition there could never be
21 any adverse effect. Mr. Kahan's attempt to split hairs must be rejected for its obvious
22 transparency: If the purpose of the statute was, in its broadest sense, to facilitate and
23 encourage the development of competition, a provision that expresses concern as to the

24 46. Kahan (SBC), Rebuttal at 46.

25 47. *Id.*, at 47.

1 impact of a merger upon competition must be interpreted as including both existing and
2 potential competition.

3
4 Moreover, Mr. Kahan's attempt to dismiss the *actual competition* in which SBC and
5 Ameritech have been and are presently engaged — for wireless services in the Chicago
6 metropolitan area — as something "that will have to be dealt with through divestiture"
7 grossly understates the extent to which SBC's "Cellular One" wireless business represents
8 actual potential competition to Illinois Bell's *wireline* local services.

9
10 Q. In that regard, Mr. Kahan asserts that you are "wrong" when you suggest that SBC's
11 effort to enter the Rochester, New York local service market via its cellular affiliate was
12 not a serious effort or that the experience there was not a valid indicator of what might
13 happen in Chicago.⁴⁸ Please comment on his testimony.

14
15 A. I have discussed this issue at length in my direct testimony at 31-34, and will not repeat
16 that discussion here. I would, however, respond to Mr. Kahan's contention by making
17 several observations which work to belie his claim that SBC had abandoned any interest
18 in entering Chicago long before it decided to acquire Ameritech.

19
20 According to the Joint Proxy Statement for the SBC/Pacific Telesis merger, discussions
21 between the CEOs of Pacific and SBC regarding a possible merger of the two companies
22 began in November, 1995, but were deferred until after the passage of the 1996 federal

23 48. *Id.*, at 66-77.

1 *Telecommunications Act*.⁴⁹ In testimony filed with the California PUC in October,
2 1996, Mr. Kahan specifically identified Chicago as a market that met all of SBC's entry
3 criteria specifically because of its large cellular presence, and that it was at that time
4 examining such entry.⁵⁰ The possibility of SBC acquiring another RBOC was
5 specifically raised during the California PUC October-November, 1996 CPUC hearings
6 on the Telesis/SBC merger and, indeed, was even addressed in the final California PUC
7 decision approving the merger.⁵¹ By the time that SBC "attempted" its entry into the
8 Rochester market in early 1997, it was clear that the Company was affirmatively pursuing
9 an RBOC merger/acquisition strategy rather than *de novo* local entry. Since that strategy
10 would not have been served by any actual competitive presence in another RBOC region,
11 it is entirely conceivable that SBC was by early 1997 far more interested in looking for a
12 way to extricate itself from Mr. Kahan's discussion of the Company's interest in Chicago
13 than to pursue that initiative. The effort, if you could call it that, in Rochester was little
14 more than "a lick and a promise." The whole thing lasted for only a few months, no new
15 personnel were recruited, all of two vehicles were purchased, and the entry conditions
16 were anything but conducive to success.⁵² As I indicated in my direct testimony, both
17 AT&T and Time Warner had previously entered and withdrawn from the residential

18 49. *In the Matter of the Joint Application of Pacific Telesis Group and SBC*
19 *Communications Inc. for SBC to Control Pacific Bell (U 1001 C), Which Will Occur*
20 *Indirectly as a Result of Telesis' Merger With a Wholly Owned Subsidiary of SBC, SBC*
21 *Communications (NV) Inc.*, Calif. PUC A.96-04-038, Joint Application, April 26, 1996,
22 Exhibit F at 19.

23 50. Calif. PUC A.96-02-028, Rebuttal Testimony of James S. Kahan (SBC), at 3-4.

24 51. Calif. PUC A.97-03-067, A. 96-04-038, March 31, 1997, at 93.

25 52. Sigman (SBC), FCC Affidavit, at ¶¶ 6,7. Emphasis supplied.

1 market in Rochester, and the "resale discount" being offered by Frontier Communications
2 (formerly Rochester Telephone Corporation) was a paltry 5%.⁵³

3
4 This feeble SBC effort in Rochester is in stark contrast to the description of the
5 Company's plans that SBC (through its mobile services subsidiary, Southwestern Bell
6 Mobile Systems, Inc. (SBMS)) offered the Illinois Commerce Commission when, *in*
7 *1995*, it sought certification as a CLEC in the Chicago MSA:

8
9 5. SBMS Illinois intends to provide high quality and all forms of local
10 exchange and interexchange telecommunications services on both a facilities and
11 resale basis within the specified geographic area. SBMS Illinois proposes to resell
12 various voice and data communications services offered by Ameritech-Illinois, Centel
13 and new local exchange carriers, such as MFS Intelenet of Illinois, Inc. SBMS
14 Illinois will construct its own transmission and switching facilities to augment
15 existing infrastructure to the greatest extent possible. Facilities-based and resold
16 services will be packaged to suit specialized needs of customers. SBMS Illinois'
17 intent is to introduce state of the art technology as rapidly as possible to obtain
18 competitive advantages in the provision of telecommunications services and to
19 purchase and resell services based on state of the art technology being utilized by
20 other telecommunications carriers to provide telecommunications services.

21
22 6. ... Unlike many of the new entrants, Cellular One-Chicago has already built
23 and is operating its network and providing ubiquitous geographic coverage
24 throughout the Chicago metropolitan area. Cellular One-Chicago has in excess of
25 400 cell sites throughout the area with the cell sites being linked by fiber optic or
26 other landline trunks (or microwave facilities) to form a backbone network serving
27 the Chicago metropolitan area. With the integration of the operations of SBMS
28 Illinois and Cellular One-Chicago, prospective landline customers throughout the
29 Chicago metropolitan area would only need to be linked to the closest cell site in
30 order to be linked to the backbone network. As this Commission is aware, Cellular

31 53. New York Public Service Commission, *Petition of Rochester Telephone Corporation*
32 *for Approval of Proposed Restructuring Plan*, Case 93-C-0103; *Petition of Rochester*
33 *Telephone Corporation of Approval of a New Multi Year Rate Stability Agreement*, Case 93-
34 *C-0033; Opinion and Order Approving Joint Stipulation and Agreement*, Opinion No. 94-25,
35 Issued and Effective November 10, 1994, at 26.

1 One-Chicago has hundreds of thousands of customers throughout the Chicago
2 metropolitan area made up of residential and small business customers as well as
3 large businesses. The integration of the operations of SBMS Illinois and Cellular
4 One-Chicago will allow the introduction and provision of new services and
5 economically attractive packages not only to those customers but prospective
6 customers, as well. Cellular One-Chicago has an extensive distribution system
7 throughout the Chicago metropolitan area; and the proposed integration will allow
8 the early availability of competitive alternatives throughout the area, as well as the
9 benefits of "one-stop shopping" for wireline and wireless services or combinations
10 thereof.

11 . . .

12
13
14 8. SBMS Illinois possesses sufficient technical, financial and managerial
15 resources and abilities to provide services it seeks to provide as required by § 13-
16 403, § 13-404, and § 13-405 of The Public Utilities Act ("Act"). ... SBC and its
17 affiliates will provide all funds necessary for SBMS Illinois to provide the proposed
18 local exchange and interexchange services. SBC and its affiliates will fully staff
19 SBMS Illinois with qualified and experienced managerial and technical personnel.⁵⁴
20

21 A copy of the SBMS Applications is provided as Appendix 2 to this rebuttal testimony.
22 Underscoring and reaffirming its plans to *compete* in out-of-region markets *including*
23 Rochester as well as Chicago, in a 1995 petition to the FCC for a waiver of the FCC's

24 54. *In the Matter of SBMS Illinois Services, Inc. Application for a Certificate of Local*
25 *Exchange Service Authority and Certificate of Service Authority to Resell Local and IntraMSA*
26 *Interexchange Telecommunications Services Within Those Portions of Market Service Area 1*
27 *served by Illinois Bell Telephone Company, d.b.a. Ameritech Illinois, and Central Telephone*
28 *Company of Illinois and for a Certificate of Interexchange Service Authority to Provide*
29 *Facilities-Based IntraMSA Interexchange Services Within Market Service Area 1*, ICC Docket
30 95-0347, filed July 21, 1995.

1 rules requiring separate subsidiaries for cellular and wireline services,⁵⁵ SBC told the
2 FCC that:

3
4 ... SBMS proposes initially to provide integrated cellular and CLLE [competitive
5 landline local exchange] service in Rochester, New York, and thereafter in other out
6 of region markets where SBMS provides cellular service. FOOTNOTE: As
7 described more fully in this Motion, this is precisely the type of integrated service
8 which other telecommunications companies are now offering in Rochester and are
9 proposing to offer in other markets, and with which SBMS must compete. SBMS is
10 *not* seeking a ruling which would permit SBMS (or a closely-integrated corporate
11 affiliate) to provide CLLE by *acquiring* the existing LEC in any market. Rather,
12 SBMS's entry will be on a *competitive* basis, either through direct entry itself or
13 through acquisition of another competitor, but *not* as a replacement for the existing
14 LEC.⁵⁶

15
16 . . .

17
18 [Following receipt of certification in New York and granting of the FCC motion]
19 SBMS and SBMS-NY Services intend to integrate their facilities, operations and
20 personnel in the provision of cellular and CLLE service in Rochester, New York;
21 thereafter, upon receipt of appropriate state certifications, SBMS and its affiliates
22 [footnote omitted] will proceed with the provision of such service in other out of
23 region cellular markets.⁵⁷

24
25 . . .

26
27 ... With one (or more) sophisticated switches already in place in each market, SBMS
28 could rapidly provide switching capabilities, so that new services could be offered
29 beyond the services made available for resale by the existing LEC.⁵⁸

30 55. *Motion of Southwestern Bell Mobile Systems, Inc. for a Declaratory Ruling That*
31 *Section 22.903 and Other Sections of the Rule of the Commission Permit the Cellular Affiliate*
32 *of a Bell Operating Company to Provide Competitive Landline Local Exchange Service*
33 *Outside the Region in Which the Bell Operating Company is the Local Exchange Carrier,*
34 *Motion for Declaratory Ruling, CWD Docket No. 95-5, dated June 21, 1995.*

35 56. Motion, at ii. Emphasis in original.

36 57. Motion, at iv.

37 58. Motion, at 7.

1 . . .

2
3 As explained in this Motion, SBMS anticipates first providing CLLE service in
4 Rochester, New York. Initially, local exchange services will be purchased from the
5 existing LEC, Rochester Telephone Corporation ("Rochester Telephone"), and resold
6 pursuant to Rochester Telephone's "Open Market Plan" (footnote omitted). Some
7 elements of local service, such as the loops, will probably be provided by resale even
8 after other facilities have been acquired by lease or purchase. In order to succeed
9 under these circumstances, SBMS would have to be at least as efficient as its
10 competitors and be able to offer similar services or packages. To attain the required
11 efficiencies, SBMS need to begin as soon as possible to use its own cellular
12 facilities, systems, and personnel to provide some services which will be part of the
13 CLLE service.⁵⁹
14

15 A copy of the SBC waiver petition is provided as Appendix 3 to this rebuttal testimony.
16 These 1995 statements, both of which were made before any of the RBOC merger
17 discussions were initiated, simply do not square with SBC's current posturing, motivated
18 as it is to disavow any possibility of SBC being considered an actual potential competitor
19 in any out-of-region ILEC market that it might plan to acquire. Indeed, the portrayal of
20 SBC's local entry plans in the above-referenced pleadings should have a familiar ring in
21 the context of the present proceeding, in that they sound an awful lot like Mr. Kahan's
22 descriptions of the Applicants' "National-Local Strategy." One can readily envision a
23 similar reversal of position relative to the National-Local Strategy if, for example, the
24 post-merger SBC decides to merge with/acquire US West, BellSouth, Cincinnati Bell,
25 Frontier, or even Bell Atlantic/NYNEX/GTE! It's easy for Mr. Kahan to summarily
26 claim that I am "wrong;" however, SBC's own words confirm the accuracy of my
27 analysis.
28

29 59. Motion, at 8-9.

1 Q. Mr. Gebhardt contends that this Commission should defer to the United States
2 Department of Justice (DoJ) as to any evaluation of the effect of the merger upon
3 competition, actual or potential. Specifically, he suggests that "[t]hese are technical areas
4 which the DOJ has the expertise to analyze." Should the Commission subordinate its
5 obligations under Section 7-204(b)(6) to the DoJ as Mr. Gebhardt recommends?
6

7 A. While I am not an attorney and thus do not offer a legal opinion, it seems to me that if
8 the Illinois legislature had intended that the Illinois Commerce Commission simply defer
9 to the Department of Justice for a ruling on the impact of a merger upon competition,
10 rather than conducting its own investigation in the context of Illinois law and policy, it
11 would have so stated when enacting Section 7-204(b)(6). Moreover, I would take strong
12 issue with Mr. Gebhardt's suggestion that the DoJ somehow possesses expertise on "these
13 technical areas" that this Commission lacks. In fact, the opposite is likely the case. The
14 DoJ has little if any experience dealing with competition in the *local* telecommunications
15 business. Indeed, its stance in the last major telecommunications antitrust case, which led
16 to the break-up of the former Bell System, was expressly premised upon the notion that
17 there was *no competition* in the local exchange market, and that for this reason the local
18 market needed to be structurally separated from the then-*potentially competitive* long
19 distance, manufacturing and information services markets. It is noteworthy that, at the
20 time of the initial settlement of the 1974 antitrust case on January 8, 1982, there was
21 virtually no effective competition in any of these adjacent markets, and the specific
22 policy goal of the divestiture decree was to develop the potential competition in each of
23 them - an outcome that may well go down as one of the most successful antitrust results
24 in US history.

1 In fact, the DoJ's decisions not to oppose previous RBOC mergers appear to essentially
2 ignore the impact of these consolidations upon potential competition: Under the theory
3 being advanced to and apparently being accepted by the DoJ (at least up until now), if
4 the entities do not presently compete with one another, then there is no diminution of
5 competition, *even if the individual companies each control more than 98% of their*
6 *respective markets*. This Commission is charged with assessing the impact of the merger
7 upon the public interest, which is a far broader standard than that to which the DoJ
8 review is subject. If the current "public interest" paradigm in Illinois (and, for that
9 matter, at the national level as well) is premised upon increased competition and reduced
10 regulation of local telephone companies, then consideration of the public interest impact
11 requires an examination of the effect of the merger upon potential competition. That is
12 clearly what the Illinois legislature intended, and that is the standard that this
13 Commission should adopt in evaluating the public interest impact of this transaction.
14

15 Q. Dr. Selwyn, Dr. Harris states that "[a] showing of anticompetitive effects of a merger
16 from a reduction in potential competition requires that all three of the following
17 conditions be met: (1) the merger eliminates a firm that would have entered the market as
18 a new competitor, (2) the merger eliminates a firm that is one of only a few firms that
19 are uniquely situated to enter the market in the near future, and (3) the merger eliminates
20 a firm whose entry would have a substantial deconcentrating effect on a concentrated
21 market." Would the proposed merger of SBC and Ameritech satisfy all three of these
22 conditions, particularly with respect to competition *in Illinois*?
23

1 A. Indeed, all three conditions would clearly be met by the proposed transaction. First, as I
2 have discussed in detail and as SBC's own filings with this Commission and with the
3 FCC confirm, "the merger eliminates a firm that would have entered the market as a new
4 competitor." But for its adoption of an RBOC merger/acquisition strategy, SBC would
5 have entered the Chicago metropolitan area local service market via its SBMS d/b/a
6 Cellular One affiliate, which I estimate currently serves more than one million customers
7 and, as I noted in my direct testimony, has nearly three million telephone numbers
8 assigned to it. Second, "the merger eliminates a firm that is one of only a few firms that
9 are uniquely situated to enter the market in the near future." In its Application, SBMS
10 described itself as being "[u]nlike many of the new entrants," noting that "Cellular One-
11 Chicago has already built and is operating its network and providing ubiquitous
12 geographic coverage throughout the Chicago metropolitan area." Indeed, as the adjacent
13 RBOC with extensive switching and transport facilities in the Chicago area (as noted in
14 the SBMS Application discussed above) — in fact, probably with more capital
15 investment in the Chicago area than any telecommunications firm other than Ameritech
16 — SBC is "uniquely situated" to compete in this market. Moreover, as I have noted
17 above, if both the SBC/Ameritech and Bell Atlantic/GTE mergers are approved, and
18 further assuming the accuracy of Mr. Kahan's assessment that SBC without Ameritech is
19 too small to pursue *de novo* local entry, there will then be only two companies whose
20 size exceeds the minimum viable scale needed for effective competition in the local
21 market at a national level. This also works to support the third of Dr. Harris'
22 "conditions," namely that "the merger eliminates a firm whose entry would have a
23 substantial deconcentrating effect on a concentrated market." With Ameritech controlling
24 at least 97% of the local exchange market (and arguably more than 99%, if resold lines

1 are excluded) within its operating areas, this is clearly one of the most concentrated
2 markets in existence.⁶⁰ The entry of SBC into the wireline local exchange market via
3 its mobile services affiliate would have presented Illinois Bell with a serious competitive
4 challenge, and would have represented far more than a mere niche market entry. Indeed,
5 where SBC does compete with Ameritech in the cellular market, its share is likely of the
6 order of 50%. The particular "spin" that Dr. Harris seeks to place upon these three
7 conditions rests entirely upon the veracity of SBC's claim that it would not use its
8 million-customer, 400+ cell site cellular business as a springboard for a serious local
9 competition initiative. As I have shown, that claim is belied by SBC's own
10 representations to this Commission and to the FCC, and the convenient attempt at
11 revisionism for purposes of nominally satisfying the merger guidelines must be rejected
12 as little more than posturing.

13
14 Q. Mr. Kahan contends that if the merger is approved (thereby eliminating SBC as an actual
15 potential competitor of Ameritech, even if it were one) Ameritech will still confront four
16 major competitors in the Illinois local service market — AT&T, MCI, Sprint (actual
17 competitors), and the post-merger Bell Atlantic/GTE as a potential competitor. Do you
18 agree?

19
20 A. No. First, I would note that this contention is inconsistent with Mr. Kahan's view that
21 *all* existing CLECs are fundamentally *niche* players, and that in fact it is only the kind of

22 60. Ameritech's response to the FCC's *2nd Survey*.

1 mass-scale entry that SBC's National-Local Strategy contemplates that would represent
2 serious competition in the local exchange service market:

3
4 Clearly, there are dozens and there will probably be hundreds, if not thousands, of
5 CLECs that have established themselves and will continue to establish themselves as
6 viable and valuable niche players and telecommunications service providers through
7 the standard CLEC model of entry. These companies will be successful in their
8 niche. However, in order for a company to position itself as a national and global
9 provider of full-service telecommunications, SBC has come to the conclusion that a
10 National-Local Strategy is critical to competing for customers who want full
11 integrated services on a broad geographic basis as well as one-stop shopping.⁶¹
12

13 As I have previously noted, neither AT&T nor MCI have any legacy of managerial
14 experience in the local service business, except (in the case of MCI Worldnet) as a
15 Competitive Access Provider. Sprint does own a number of small local telcos following
16 its merger with United Telecom, but certainly does not possess the large customer base
17 that a post-merger SBC/Ameritech would have from which to launch an out-of-region
18 entry strategy. In their Joint Merger Application, Bell Atlantic and GTE have presented
19 their own counterpart of a National-Local Strategy that calls for entry into 21 out-of-
20 region markets *if their merger is approved*.⁶² However, this planned entry is also
21 apparently conditioned on Bell Atlantic receiving FCC approval to enter the in-region
22 long distance business.⁶³ In fact, a reading of the Bell Atlantic/GTE merger application

23 61. Kahan (SBC), Rebuttal at 48-49.

24 62. BA/GTE Public Interest Statement, at 6-7.

25 63. *Id.*, at 14.

1 suggests that the Bell Atlantic/GTE commitment to out-of-region entry is not as detailed
2 as that being portrayed by SBC.⁶⁴

3
4 None of the IXC's are a match for an ILEC in terms of their ability to offer a serious
5 competitive challenge in the local exchange market. Both SBC and Ameritech maintain
6 local service market shares within their home service areas in the 98% range, perhaps
7 even higher if resale competition is discounted. The largest IXC — AT&T — controls
8 just 40% of the long distance market nationwide.⁶⁵ The vast majority of SBC's and
9 Ameritech's customers confront no alternative to the ILECs' local services, whereas
10 virtually every IXC customer — from the smallest households to the largest national and
11 multinational corporations — can readily and often costlessly shift interexchange carriers.
12 In my direct testimony (at page 23), I observed that Mr. Kahan, in describing the SBC
13 National-Local Strategy, noted that SBC has "identified 224 Fortune 500 companies that
14 are headquartered in the 13 states served by SBC, Ameritech and SNET."⁶⁶ None of the
15 IXC's mentioned as "actual competitors" by Mr. Kahan has a monopoly service relation-
16 ship with *any* customer; yet Dr. Dennis W. Carlton, testifying for SBC in its FCC
17 Application and citing Mr. Kahan's FCC affidavit, underscores the critical importance

18 64. The BA/GTE Public Interest Statement claims that the merger will "erase ...
19 limitation[s]" and provide "greater ability" to enter out-of-region local markets, and create
20 "real-world conditions necessary to succeed" in entry. Instead of a direct commitment to
21 enter new markets, the statement simply quotes from GTE's Chairman regarding "plans" of
22 the combined Company. *Id.*, at 1-2, 6.

23 65. Statistics of Communications Common Carriers, 1997, Table 1.6, based on revenues of
24 all long distance toll providers.

25 66. Kahan (SBC), FCC Affidavit at ¶ 49.

1 that this relationship with nearly half of the 500 largest US corporations has in SBC's
2 national market strategy:

3
4 SBC and Ameritech have concluded that they now cannot adequately respond to
5 these changing conditions as regionally limited suppliers of local services. In
6 particular, the regional structure of SBC and Ameritech leaves them poorly situated
7 to provide national (or near national) coverage to large business customers. ...⁶⁷
8

9 I have analyzed the ability of SBC and Ameritech to use their own facilities to serve
10 multilocation customers using estimates of telecommunications expenditures by MSA
11 [Metropolitan Statistical Area] for each of the Fortune 500 companies. These data ...
12 reflect estimates of expenditures for local and long distance services [and] indicate
13 that SBC's eight home-state region is headquarters to 129 Fortune 500 companies.⁶⁸
14

15 SBC recognizes that it is important that it be able to provide a significant majority of
16 the telecommunications services these customers need -- as a sort of prime contractor
17 -- but that it is not essential that it be able to provide all of such facilities and
18 services. The ability to provide most services is necessary, from SBC's perspective,
19 to provide overall management and quality control of the services desired by
20 customers. SBC believes that it can successfully market "national" services to
21 customers for which it directly provides roughly 70 percent or more of their national
22 expenditures.⁶⁹
23

24 The sheer fallacy of Mr. Kahan's contention cannot be overemphasized: While
25 concluding that the 129 Fortune 500 companies headquartered within SBC's existing 8-
26 state region would not be a sufficient core customer base from which to launch a
27 National-Local Strategy, the fact that neither AT&T, MCI, nor Sprint has a monopoly
28 local service (or monopoly long distance service, for that matter) relationship with *any*
29 Fortune 500 company appears to be dismissed as of no consequence to the IXC's' ability

30 67. Carlton (SBC), FCC Affidavit, ¶ 14.

31 68. *Id.*, at ¶ 15, footnote omitted.

32 69. *Id.*, at ¶ 16, footnote omitted.

1 to challenge SBC or Ameritech in the local service market. Because IXC's and CLEC's
2 have no base of monopoly local service customers, *every local service market is "out-of-*
3 *region."*

4
5 **Implementation of the National-Local Strategy will sap resources from Illinois Bell, and**
6 **requires the supporting revenue generated by Ameritech and SBC's operating companies**
7 **and their captive customer base.**
8

9 Q. Dr. Selwyn, in his rebuttal testimony, Mr. Kahan claims that the National-Local Strategy
10 is "not capital intensive."⁷⁰ How do you respond to this statement?
11

12 A. This new contention in Mr. Kahan's rebuttal testimony is quite remarkable, in light of
13 statements he made in his FCC affidavit on this point. As I discussed on pages 64-65 of
14 my direct testimony, Mr. Kahan, in his FCC Affidavit, has detailed quite specifically the
15 resources required by SBC in implementing the National-Local Strategy:

16
17 As one would expect when constructing 2,900 miles of fiber and placing into
18 operation 140 switches, SBC's National-Local Strategy will require *extensive capital*
19 *investment* and the commitment of extensive financial and managerial resources. *The*
20 *National-Local Strategy calls for the investment of more than \$2-billion in capital*
21 *expenditures.* This capital requirement is in addition to the capital requirements the
22 new SBC must bear as it continues to enhance and maintain its local exchange
23 networks in those markets where it is an in-region provider.
24

25 Over the next ten years, the operating expenses involved in these out-of-region
26 operations will be in excess of \$23.5-billion. In addition, these capital requirements
27 and operating expenses are heavily weighted towards the early years of the business
28 plan -- a return on this investment does not occur until the later years. *Indeed, the*
29 *magnitude of the investment required to sustain this venture is demonstrated by the*

30 70. Kahan (SBC), Rebuttal at 14.

1 *fact that these operations are expected to generate negative cumulative cash flow*
2 *until the ninth year of the National-Local Strategy.*⁷¹
3

4 Semantics aside, Mr. Kahan fails to explain his puzzling contention that capital
5 expenditures for the National-Local Strategy are "extensive" yet not "intensive."
6

7 Mr. Kahan's statement is all the more bewildering when you add in SBC's claims that it
8 is unable to pursue the National-Local entry strategy without the added resources of
9 Ameritech.⁷² Mr. Kahan's belated minimization of the capital requirements of the
10 National-Local Strategy flies in the face of his contention that SBC, with \$25-billion in
11 annual revenues, is too small to handle the substantial expenses created by the National-
12 Local Strategy on its own. SBC seems to be telling different stories here and in
13 Washington: Before the FCC, SBC focuses upon the substantial investment that it will
14 need to make in order to pursue its out-of-region entry program and the positive impact
15 upon local competition that is expected to result, while before this Commission, SBC
16 attempts to de-emphasize the magnitude of the National-Local entry strategy in order to
17 sidestep controversy over the issue of cross-subsidization. These arguments are
18 transparent, and should be considered by the Commission to be disingenuous at best. As
19 discussed on pages 61-67 of my direct testimony, the risk and, moreover, the outright
20 assertion by SBC that the National-Local Strategy requires a broader base of customers
21 and revenues over which to spread its costs⁷³ is a clear indication that cross-

22 71. Kahan (SBC), FCC Affidavit, at ¶¶ 57-58. Emphasis supplied.

23 72. *Id.*, at ¶¶ 11, 12, 27.

24 73. Schmalensee/Taylor (SBC/Ameritech), FCC Affidavit, at ¶ 16.

1 subsidization of the National-Local Strategy by Illinois Bell and its core base of local
2 service revenues will occur. As I discussed in my direct testimony, such cross-
3 subsidization is expressly prohibited by Section 7-204(b)(2) of the PUA and by Section
4 254(k) of the federal *Telecommunications Act*.⁷⁴ Mr. Kahan's statement, in his FCC
5 affidavit, that the National-Local Strategy will not generate a positive cash flow for
6 nearly ten years confirms the presence of precisely this type of cross-subsidization. In
7 addition, as I discussed on page 63 of my direct testimony, the staffing of the National-
8 Local Strategy with Illinois Bell managers and employees will also, in effect, rob Illinois
9 Bell of resources that have been funded largely, if not entirely, by revenues from core
10 monopoly services. The transfer of these resources to the National-Local Strategy effort
11 must also be considered when evaluating the cross-subsidization issue.

12
13 Q. In responding to this issue, Mr. Kahan states that "Illinois non-competitive services are
14 subject to a price cap that prevents Ameritech Illinois from increasing prices for these
15 services. ... as competition increases, the number of services that fall in the non-
16 competitive category will decline. The combination of the existence of the competitive
17 market and price cap should alleviate any concern which the Illinois Commerce
18 Commission might have regarding this issue."⁷⁵ Do you agree?

19
20 A. No. Mr. Kahan's assurances are entirely vacant. As I have previously discussed, Illinois
21 Bell has regularly been "declaring" various of its services to be "competitive" and thereby

22 74. See pages 61-62 of my direct testimony.

23 75. Kahan (SBC), Rebuttal at 33.

1 removing them from price cap protection. As I noted earlier, this Commission has
2 opened two separate investigations of these "reclassifications," and both this Commission
3 and the Illinois Appellate Court have expressly noted that a mere declaration by the
4 Company that a particular service is "competitive" does not make it so. While Mr.
5 Kahan may be correct in stating that services that are *classified* as "noncompetitive" are
6 subject to the price cap plan and its associated limits on rate increases, Illinois Bell has
7 been reclassifying services as "competitive" for which no actual competition exists
8 precisely for the purpose of avoiding (or perhaps evading) the operation of the
9 Commission's price cap regulation system. As the recent Staff Report noted, these
10 reclassifications have in many cases been accompanied by sharp rate increases, a result
11 that would not be expected if in fact there were real competitive choices available to
12 consumers. As I described earlier, this ability to raise prices for services declared to be
13 "competitive" (and consequently to increase revenues without any actual competitive
14 challenge) underscores the profound *lack* of competition for these services. These actions
15 should be of particular concern to the Commission in the present context, in view of
16 SBC's stated plans to rely upon Illinois Bell revenues and resources to support its out-of-
17 region entry program. Therefore, my warning of price and revenue increases and the
18 subsidization of the National-Local Strategy following the merger is anything but "simply
19 wrong" as Mr. Kahan baldly asserts;⁷⁶ Illinois Bell by its actions has demonstrated these
20 concerns to be right on target.

22 76. Kahan (SBC), Rebuttal at 33.

1 **Section 7-204(c) of the Illinois Public Utilities Act applies to utilities under price cap**
2 **regulation, and applies to this proposed merger.**
3

4 Q. In the rebuttal testimony filed in this case, the Applicants' witnesses reiterate their
5 contention that Section 7-204(c) of the PUA does not apply to utilities governed by price
6 cap regulation, and therefore disclaim any obligation to share any of the merger synergies
7 with Illinois Bell ratepayers.⁷⁷ Do the witnesses raise any arguments that were not also
8 advanced in the Applicants' direct case?
9

10 A. No, they do not. The witnesses in large part regurgitate their position that price cap
11 regulation is "designed to encourage local exchange carriers to become more efficient,"
12 and that "[s]avings that are derived as a result of efficiencies can, as long as a price cap
13 plan is kept in place, generally inure to the benefit of shareholders."⁷⁸ Mr. Kahan and
14 Dr. Harris melodramatically assert that the application of Section 7-204(c) upon price cap
15 utilities would "destroy the very means by which the alternative regulation plan is
16 designed to create incentive,"⁷⁹ and would thus discourage Illinois Bell "from
17 undertaking any actions beyond a certain size, certainly not a result envisaged or desired
18 by the Commission."⁸⁰ Mr. Kahan, for example, contends that:

19
20 It is particularly important in light of the fact that an alternative regulation plan is
21 designed to encourage local exchange carriers to become more efficient. Savings

22 77. Kahan (SBC), Rebuttal at 101-103; Harris (SBC/Ameritech), Rebuttal at 43-44; and
23 Gebhardt (Ameritech), Rebuttal at 53-64.

24 78. Kahan (SBC), Rebuttal at 102.

25 79. *Id.*, at 102-103.

26 80. Harris (SBC/Ameritech), Rebuttal at 44.

1 that are derived as a result of efficiencies can, as long as a price cap plan is kept in
2 place, generally inure to the benefit of shareholders. It is this important distinction
3 that Dr. Selwyn is completely ignoring. There is not, to my knowledge, any limit in
4 the Illinois Bell alternative regulation plan, to how cost savings are derived. If
5 Section 7-204(c) is applied to a price cap company it would destroy the very means
6 by which the alternative regulation plan is designed to create incentive.⁸¹
7

8 Each and all of these arguments were offered by the Applicants in their direct case, and
9 no additional facts or arguments are being presented in this rebuttal round.
10

11 The central point of dispute in this regard is whether or not a reinitialization of rates or a
12 revisiting of the price caps formula is in order, given the substantial efficiencies that
13 Illinois Bell will derive should the merger between Ameritech and SBC be approved.
14 Rhetoric aside, the Applicants offer no specific basis for their contention that Section
15 7-204(c) does not apply to price cap ILECs and, in particular, does not apply to this
16 transaction. In their rebuttal case they now advance a theory that the provision of the
17 PUA was actually intended for electric utilities operating under rate of return legislation,
18 and therefore it "does not make sense" for the provision to affect "only" price cap
19 companies.⁸² Mr. Gebhardt has mischaracterized my testimony by implying that I
20 believe Section 7-204(c) applies only to price cap companies: what I state on page 74 of
21 my direct testimony is that

22
23 If Illinois Bell were still subject to rate of return regulation, any net cost savings
24 arising from the merger would be flowed through to ratepayers in the routine course
25 of periodically setting the utility's revenue requirement and rate level. Section 7-
26 204(c) thus becomes operative where merger-driven cost savings would *not* otherwise

27 81. Kahan (SBC), Rebuttal at 102-103.

28 82. Gebhardt (Ameritech), Rebuttal at 77.

1 be flowed through to ratepayers, i.e., where price cap regulation, *rather than rate of*
2 *return regulation*, has been adopted.
3

4 My position is clearly not that Section 7-204(c) applies *only* to price cap companies, but
5 that price cap companies are specifically not excluded from this provision, as the
6 Applicants contend.
7

8 In defining their position, the Applicants offer no specific legislative history in support of
9 this contention, no facts to buttress this speculation, and no case law. This is clearly a
10 legal issue that will ultimately have to be briefed, but on its face the Applicants' position
11 makes no sense:
12

- 13 • When adopted, the Illinois Bell price cap plan had a finite life, and was supposed to
14 be subject to a full review in 1998 and a potential revision and/or termination in
15 1999.⁸³ Contrary to the Applicants' notion, this Commission never contemplated a
16 permanent, hands-off policy with respect to the price cap plan or any specific
17 attributes thereof.
18
- 19 • It is quite common for price cap regulation systems to be reviewed and modified, as
20 this Commission had expressly intended to do in 1998. The FCC's price cap
21 regulation system for incumbent LECs, first adopted in 1990,⁸⁴ has received major

22 83. ICC Docket No. 92-0448/93-0239 Order, at 94-95; Appendix A at 10.

23 84. *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order,
24 CC Docket No. 87-313, 5 FCC Rcd 6786 (Rel. Oct. 4, 1990).

1 modifications on two occasions since,⁸⁵ and is currently being reviewed once
2 again.⁸⁶ The California PUC's *New Regulatory Framework*⁸⁷ price cap system,
3 initially implemented on January 1, 1990, has been the subject of three (3) triennial
4 reviews, and was significantly modified in each instance.⁸⁸ In some cases, price
5 cap plans, upon review, have been discontinued. For example, US West-Washington
6 operated under an Alternative Form of Regulation (AFOR) plan during the calendar
7 years 1990-1994.⁸⁹ When the AFOR expired in December 1994, the Company did
8 not elect to renew alternative regulation, and instead filed for a \$205-million annual
9 rate increase (to be phased in over four years).⁹⁰
10

11 85. *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order,
12 CC Docket No. 94-1, 10 FCC Rcd 8961 (Rel. April 7, 1995); *Price Cap Performance Review*
13 *for Local Exchange Carriers; Access Charge Reform*, Fourth Report and Order in CC Docket
14 No. 94-1; Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642 (Rel. May
15 21, 1997).

16 86. Public Notice, FCC 98-256, released October 5, 1998, *In the Matter of Access Charge*
17 *Reform*, CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange*
18 *Carriers*, CC Docket 94-1, and *Request for Amendment of the Commission's Rules Regarding*
19 *Access Charges Reform and Price Cap Performance Review for Local Exchange Carriers*,
20 RM No. 9210.

21 87. Calif. PUC D. 89-10-031, 33 CPUC 2d 43 (1989).

22 88. A.92-05-002/A.92-05-004, D.94-06-011, 55 CPUC 2d 1; I.95-05-047, D.95-12-052,
23 63 CPUC 2d 377; and R.98-03-040, D.98-10-026 mimeo, October 8, 1998.

24 89. WUTC Docket UT-950200, *Order*, April 11, 1996, at 1. (1996 Wash. UTC LEXIS 7;
25 169 P.U.R.4th 417)

26 90. *Id.*, at 3.

- ILECs themselves, *including subsidiaries of Ameritech*, have never hesitated to seek significant modifications (in their favor) of preexisting price cap or other incentive regulation schemes.

When the price cap plan for Illinois Bell was adopted in 1994, the concept of a merger between two (or, as is really the case here, three⁹¹) Regional Bell Operating Companies was never raised and, indeed, Illinois Bell maintained the position that *past* productivity gains (upon which its Total Factor Productivity (TFP) study had been based) could not expect to be replicated in the future.⁹² The Illinois Bell price cap plan was indeed developed in order to allow carriers to become more efficient, but it was also anticipated that ultimately these efficiency gains would flow through to the Company's customers. One way in which that might happen is through the development of effective, price-constraining competition, but that has clearly not happened. Indeed, as the Commission's Telecommunications Division has noted and as I have previously discussed, Illinois Bell has typically *increased* prices upon "declaring" a service to be "competitive." It is undeniable that the proposed merger will fundamentally alter the cost structure and cost level for Illinois Bell. Section 7-204(c) clearly recognizes this outcome of a merger transaction, and correctly makes no distinction between ROR-regulated and price cap-regulated companies. There is simply no basis for the Applicants' obviously self-serving position that the Commission *never* planned to revisit and revise the price cap formula,

91. Counting SBC, Pacific Telesis and now Ameritech.

92. *In the Matter of Illinois Bell Telephone Company's Petition to Regulate Rates and Charges of Noncompetitive Services under an Alternative Form of Regulation*, ICC Docket No. 92-0448, Rebuttal Testimony of Dr. Laurits R. Christensen, Illinois Bell Exhibit 5.6, at 21.

1 that it *never* planned to independently determine that rates set under price caps remain
2 "just and reasonable," and that the Commission *did expect* that long-term, permanent cost
3 and productivity changes would inure solely to shareholders. Indeed, the opening of
4 Docket 98-0860 and 98-0861 a few weeks ago exemplifies the Commission's ongoing
5 concern as to the reasonableness of Illinois Bell's prices.

6
7 Q. Dr. Harris appears to be arguing that the magnitude of the proposed merger does not in
8 and of itself trigger any modification to the existing price cap formula. Do you agree?

9
10 A. No, and I believe that the very existence of Section 7-204(c) confirms my interpretation
11 and discredits Dr. Harris' position. According to Dr. Harris:

12
13 ... if large changes such as this were considered to be within the short list of factors
14 that could alter the price cap, Illinois Bell would be discouraged from undertaking
15 any actions beyond a certain size, certainly not a result envisaged or desired by the
16 Commission. In my view, any attempt to capture these benefits under a price cap
17 plan would constitute a violation of the implied or explicit contract between the ICC
18 and Illinois Bell.⁹³

19
20 Dr. Harris' notion that altering the price cap plan to reflect "large changes such as this"
21 was "certainly not a result envisaged or desired by the Commission" does not square with
22 the existence of Section 7-204(c). When the Illinois legislature enacted Section 7-204(c)
23 in 1997,⁹⁴ it was well aware that Illinois Bell was, at that time, subject to price cap
24 regulation. Nevertheless, the legislature made no reference to, nor provided any

25 93. Harris (SBC/Ameritech), Rebuttal at 44.

26 94. The "Electric Service Customer Choice and Rate Relief Law of 1997," Public Act 90-
27 561, adopted December 16, 1997.

1 exemption for, Illinois Bell or other "price cap" utilities. Indeed, even if *arguendo* Dr.
2 Harris is correct that the *Commission* never envisaged a merger of this type, the Illinois
3 *legislature* clearly did, and provided specific procedures to be followed by the
4 *Commission* in such an event. Moreover, while the 1997 law amended certain sections of
5 the PUA that were expressly associated with electric utilities, the adoption of Section
6 7-204(c) was distinctly *not* placed in any industry-specific section of the code, but was
7 instead made applicable to *all utilities* under the Commission's jurisdiction. Additionally,
8 the 1997 law, as it applied specifically to electric utilities, expressly contemplated the
9 adoption of some form of incentive regulation in place of rate-of-return regulation for
10 these companies,⁹⁵ yet placed no limitations or caveats as to the applicability of Section
11 7-204(c) only to rate-of-return regulated utilities as the Applicants here contend.

12
13 Mr. Gebhardt argues that "the bill adding Section 7-204(c) ... was aimed at the electric
14 utility industry in Illinois, and most or all electric utilities are under rate-of-return
15 regulation. It simply would not make sense for the General Assembly to include in a bill
16 aimed at rate-of-return companies a provision that affected only price cap companies and
17 not to specifically state that restriction in the statute."⁹⁶ What Mr. Gebhardt overlooks
18 completely is the fact that the "Electric Service Customer Choice and Rate Relief Law of
19 1997" addressed, among other things, modifications to the traditional monopoly rate-of-
20 return form of regulation for electric utilities: Mr. Gebhardt has it completely backwards.
21 If Mr. Gebhardt's fanciful reading of Section 7-204(c) were correct, what would "make

22 95. 220 ILCS 5/16-111(a)(1) (1997, as amended).

23 96. Gebhardt (Ameritech), Rebuttal at 77.

1 no sense" is for the General Assembly to have enacted legislation that expressly
2 contemplated the elimination of rate-of-return regulation for electric utilities while
3 simultaneously inserting into the PUA a provision that was supposed to apply only to
4 rate-of-return companies but without actually stating as such. There is simply no support,
5 factual, logical or otherwise, for the Applicants' obviously self-serving reading of Section
6 7-204(c).

7
8 Q. Mr. Gebhardt claims that "Staff is leaving the Alternative Regulation Plan intact, but
9 capturing for ratepayers a financial benefit that would only accrue to them under full
10 rate-of-return regulation, with all of its negative baggage from a ratepayer's perspective.
11 Staff's "pick and choose" approach to regulatory paradigms is contrary to the Alternative
12 Regulation Plan Order and constitutes poor regulatory policy.⁹⁷" Do you agree?

13
14 A. I agree with part of his statement. Mr. Gebhardt's comment that but for some specific
15 adjustment to the alternative regulation plan or other one-time flow-through arrangement,
16 the "financial benefit [of the merger] would only accrue to [ratepayers] under full rate-of-
17 return regulation." Mr. Gebhardt appears to be conceding that ratepayers will not receive
18 any financial benefit of the merger through, for example, the alleged increase in
19 competition that the Applicants claim will result from the transaction, that the only way
20 that ratepayers could receive any of financial benefit would be "under full rate-of-return
21 regulation." Of course, this is precisely why Section 7-204(c) must be applied to this
22 transaction, because as Mr. Gebhardt now readily concedes, ratepayers would otherwise

23 97. *Id.*, at 62.

1 receive no financial benefit whatsoever. While SBC and Ameritech may *wish* that
2 utilities operating under price caps had been exempted from this Section or that the
3 Section would apply only to electric utilities, no such exemption or limitation can be
4 found in the statute, and the Commission must construe it as being fully applicable and
5 operative here.

6
7 Q. Has Illinois Bell ever sought to modify the price cap formula on the basis of some
8 change that, according to the Company, had affected its costs or productivity growth?

9
10 A. Indeed it has. On March 31, 1998, the Company provided the Commission with a "new"
11 study by its productivity consultant, Dr. Laurits Christensen, purporting to show that the
12 X-factor that had been set in Docket 92-0448/93-0239 at 4.3% should be reduced to
13 2.1%.⁹⁸ The timing of that filing is significant, because it occurred just five weeks
14 before the May 11, 1998 merger announcement. Thus, at the very same time that
15 Ameritech was (presumably) in discussions with SBC about merging, it was advising this
16 Commission that its future productivity gains would actually be *less*, not more, than in
17 the past, and was specifically asking the Commission to *reduce* the X-factor, i.e., to
18 modify the price cap formula for the benefit of Illinois Bell. When the "shoe is on the
19 other foot," as here, Illinois Bell now seeks to portray the existing price cap formula as
20 somehow inviolate.

21
22 _____
23 98. ICC Docket No. 98-0252, *Illinois Bell Telephone Company Application for Review of*
24 *Alternative Regulation Plan*, Section 2, "An Assessment of Productivity Gains for the U.S.
25 Economy, Telecommunications Industry, and Ameritech Illinois, and an Assessment of the
Price Cap Offset," Laurits R. Christensen Associates, Inc., March 31, 1998, at 4.

1 Q. Dr. Selwyn, you appeared as a witness in the SBC/SNET acquisition proceeding before
2 the Connecticut Department of Public Utility Control, is that correct?

3
4 A. Yes, I appeared as a witness for the Connecticut Office of Consumer Counsel.

5
6 Q. In your testimony in that matter, did you recommend that the Alternative Regulation Plan
7 that the Connecticut DPUC had adopted for SNET in 1996 be modified to reflect the
8 significant capital acquisition cost and expense reductions that SBC and SNET expected
9 to arise from their transaction?

10
11 A. Yes, I did.

12
13 Q. Did the DPUC agree that the SNET price cap formula should be revised in light of the
14 SBC takeover?

15
16 A. Yes. In its order, the DPUC agreed that the Connecticut Alternative Regulation Plan
17 should be modified specifically to capture the cost savings arising from the change of
18 control:

19
20 The Applicants [SBC and SNET] also argue that the alternative regulation plan
21 was designed to incent SNET to reduce costs and increase savings and exceed
22 the 5% productivity offset contained in the Alt Reg Plan. Any attempt to alter
23 the Alt Reg Plan would change the intent of the plan. Applicants' Reply Brief,
24 pp. 39 and 40. The Department disagrees. *The magnitude of the changes*

1 *brought by both the Merger and the restructuring significantly alter the basis for*
2 *the Alt Reg Plan.*⁹⁹
3

4 The Department stated further that the "[Office of Consumer Counsel] argues and the
5 Department agrees that the change in SNET's procurement costs and expenses have a
6 material and enduring effect that was not contemplated when the Department established
7 the price cap formula productivity factor" and stated that the "Department does not
8 believe, nor will it permit the Telco to dictate those conditions under which the Alt Reg
9 Plan can or cannot be modified especially when the benefits of such could flow to the
10 Telco's customers."¹⁰⁰
11

12 Q. Mr. Kahan also suggests that "price cap regulation ... is designed to incent a local
13 exchange company to invest efficiently."¹⁰¹ Who would be bearing the risk of the
14 capital investments that are contemplated by the merger?
15

16 A. Contrary to Mr. Kahan's implication, the primary risktaker would be consumers, not
17 shareholders, an expectation that is reflected in the Applicants' filing at the FCC:

18 "A substantial base of current customers and revenues is necessary *to maintain*
19 *earnings growth and spread risk* while following customers into out-of-region local
20

21 99. Connecticut Docket No. 98-02-20, *Joint Application of SBC Communications Inc. And*
22 *Southern New England Telecommunications Corporation for Approval of a Change of*
23 *Control, Decision*, September 2, 1998 ("*Connecticut Merger Decision*") at 52. Emphasis
24 supplied.

25 100. *Id.*, at 51.

26 101. Kahan (SBC), Rebuttal at 102.

1 markets."¹⁰² To whom would this "risk" be spread? Clearly, to customers of
2 Illinois Bell's regulated noncompetitive services.
3

4 As an aside, it is worth noting that, while the Illinois price cap plan provides a
5 mechanism for shifting services from the "noncompetitive" to the "competitive" category,
6 there is no corresponding mechanism for commensurately shifting the *costs* of these
7 services from those covered by price caps to those falling outside of its scope. If, for
8 example, Illinois Bell were to shift revenues out of price caps disproportionately relative
9 to costs, it could potentially argue that its "noncompetitive" services are failing to earn an
10 adequate rate of return, and thereby seek additional rate relief or a modification of the
11 price cap formula. There is no specific check, under the current price cap regime, to
12 constrain or, for that matter, even to monitor, such behavior. If SBC taps into Illinois
13 Bell assets, earnings, personnel or other resources to support its out-of-region National-
14 Local Strategy or other competitive entry programs, it will be Illinois ratepayers, not SBC
15 shareholders, who will ultimately bear the risk of loss.
16

17 **Illinois consumers are entitled to share the benefits of the proposed merger.**
18

19 Q Dr. Selwyn, Mr. Gebhardt argues that your proposal for allocation of merger synergies is
20 "... inconsistent with the statute, is inconsistent with the principles underlying Ameritech
21 Illinois' Alternative Regulation Plan and constitutes poor public policy. ..." ¹⁰³ Please
22 comment on this statement.
23

24 102. Schmalensee/Taylor (SBC/Ameritech), FCC Affidavit, at ¶ 16. Emphasis supplied.

25 103. Gebhardt (Ameritech), Rebuttal at 75.

1 A As explained on pages 73-77 of my direct testimony, my recommendations are fully
2 consistent with both the PUA and the federal *Telecommunications Act* and aim at
3 ensuring that Illinois consumers realize their share of the economic benefits arising
4 directly from the merger transaction. Contrary to the Applicants' contention that no
5 savings resulting from the merger should be allocated to Illinois consumers, my
6 recommendations reflect the principles established by the PUA and the federal Act, and
7 thereby ensures that Illinois consumers benefit from the efficient use of assets they have
8 funded under rate-of-return regulation and under the current price cap system, whose
9 rates were established at the same levels extant under rate-of-return regulation and
10 therefore reflect the full ratepayer responsibility that characterize rate-of-return regulation
11 for investment recovery and return on investment. As such, the approach that I
12 recommend is sound public policy, which reflects the interests of all players and aims at
13 protecting ratepayers from monopolistic and anticompetitive behavior on the part of
14 Illinois Bell, Ameritech Corporation, and the post-merger SBC.

15
16 Q. In attempting to criticize your calculations of synergy benefits that should be flowed
17 through to Illinois ratepayers, Mr. Gebhardt states:

18
19 Dr. Selwyn's calculations are based on totally inappropriate assumptions and should
20 be rejected. First, he allocates virtually all of the estimated synergies (both those
21 attributable to Ameritech and those attributable to SBC) to Ameritech. In effect, this
22 would transfer operating efficiencies achieved in Texas (for example) to Ameritech
23 Illinois' ratepayers. This is per se unreasonable, regardless [sic] what form of
24 regulation a company operates under. Second, Dr. Selwyn's allocation improperly
25 contains both revenue enhancements and savings. Third, Dr. Selwyn's calculations
26 are based on estimates, not actual operating results. This is wrong for the reasons
27 stated by both Staff and myself. Fourth, Dr. Selwyn's estimate of the percentage of
28 Ameritech Illinois' intrastate operations that are associated with noncompetitive

1 services is not based on current data. Fifth, Dr. Selwyn's use of a 10-year
2 amortization period is inappropriate.¹⁰⁴
3

4 Please comment on each of the above contentions.
5

6 A First, I should point out that some of the above items are simply hollow statements with
7 absolutely no supporting evidence or justification provided by Mr. Gebhardt, and should
8 therefore be disregarded. That notwithstanding, I shall explain why Mr. Gebhardt is
9 wrong in all respects.
10

11 First, Mr. Gebhardt has clearly misunderstood the sound basis for the \$15.4-billion
12 estimate of aggregate synergy gains inuring to Ameritech that I used as the starting point
13 in calculating the amount to be allocated to Illinois ratepayers. As explained on page 79
14 of my direct testimony:

15
16 In calculating the gains to be flowed to Illinois ratepayers, the Commission need only
17 concern itself with the portion of the merger synergies that are attributed to
18 Ameritech shareholders, because these synergies represent the increase in value of
19 the Ameritech network that has been financed largely at the captive ratepayers'
20 expense. The proper assessment of the amount to flow to Illinois ratepayers would
21 be to first determine the amount of the merger synergies attributed to Ameritech
22 shareholders, and then to determine the appropriate portion to allocate to Illinois
23 regulated intrastate telco operations.
24

25 Mr. Gebhardt's concern over where the efficiencies actually occur is irrelevant since,
26 according to the structure of the merger, Ameritech shareholders reap a disproportionate
27 share of the forecasted benefit of the merger (via the \$13.2-billion premium and the

28 104. Gebhardt (Ameritech), Rebuttal at 91-92.

1 forecasted increase in stock prices). I would observe, incidentally, that merely because a
2 merger-related cost savings is realized in Texas or anywhere else in the SBC empire does
3 not *per se* mean that Illinois ratepayers are not entitled to a share of that savings *if it was*
4 *SBC's access to Illinois Bell-supported assets (software, systems, best practices,*
5 *experienced management personnel, etc.) that made such Texas savings possible.* The
6 relevant issue here is not the geographic location at which the savings are actually
7 realized, but rather the source of the savings themselves. If Illinois ratepayers funded
8 and/or bore the principal risk associated with the acquisition of the resources in question,
9 then Illinois ratepayers must be provided a portion of any benefits arising therefrom, no
10 matter where those benefits are realized. Section 7-204(c) is wholly consistent with this
11 "reward follows risk" principle.

12
13 Second, there is no reason why revenue enhancements should not be included in the
14 calculations, because such added revenues represent additional returns on ratepayer-
15 funded assets. In fact, if those revenue enhancements are the result of Ameritech's "best
16 practices" as well as of the use of ratepayers funded assets, then Illinois ratepayers are
17 entitled to share in the benefits resulting from the efficient use of those resources and
18 assets. I would note, incidentally, that the Staff has also included revenue enhancements
19 within its definition of "merger synergies."¹⁰⁵

20
21 Third, Mr. Gebhardt's criticism of my use of "estimates" is clearly off point. Obviously,
22 the various merger synergies won't be realized until after the merger takes place, and the

23 105. Marshall (Staff), at 19.

1 ultimate dollar value of these synergies cannot be known with precision for many years.

2 On the other hand, SBC and Ameritech *directors* and *shareholders* seem to have no diffi-
3 culty in relying upon "estimates" and "projections" of merger synergies in structuring
4 their transaction, and the *arm's length* character of that transaction must be afforded
5 considerable weight. My calculations are based upon SBC and Ameritech's own
6 estimates of merger synergies, which have been the basis for the two companies'
7 determination of the premium to be paid by SBC to Ameritech and other terms of the
8 merger agreement.

9
10 Q. Staff has argued that shared benefits should be based upon actual incurred synergies and
11 allocated when they are achieved.¹⁰⁶ Do you agree?

12
13 A. No, I do not. The Applicants' respective directors and shareholders seem to be
14 untroubled by the obvious need to rely upon projections of potential synergies and other
15 merger-related benefits, and there is no reason why the allocation of benefits to
16 ratepayers should be on any different basis. Indeed, once the transaction has been
17 consummated, it may be extremely difficult to trace specific cost reductions directly to
18 the merger, and it is a reasonable assumption that any attempt to do so will be challenged
19 on factual grounds by the post-merger SBC. The Commission has before it a set of
20 projections upon which a \$62-billion arm's length transaction has been structured, and
21 this is the best source of data available upon which the Commission can base the Section
22 7-204(c) allocation. The various merger synergies estimated and provided in this case are

23 106. Marshal (Staff), Direct at 21; Yow (Staff), Direct at 26-30.

1 reasonable and may indeed be underestimated, since they do not reflect any of the
2 financial benefits that will be achieved after the National-Local Strategy is implemented.
3 In fact, in recent Reply Affidavits filed in the FCC proceeding dealing with the proposed
4 SBC/Ameritech merger, witnesses for the Applicants have provided further reinforcement
5 that the synergy estimates are real, accurate and expected. In justifying the significant
6 size of the premium over market value to be paid by SBC for Ameritech, Mr. Kahan
7 states:

8
9 The merger will indeed allow us to realize significant in-region savings
10 unrelated to the National-Local Strategy, but *the aggregate value of those*
11 *savings approximately equals the premium paid to Ameritech's shareholders*
12 *when they exchange their stock for the new SBC stock.*¹⁰⁷
13

14 Of course, the equating of "the premium paid to Ameritech's shareholders when they
15 exchange their stock for the new SBC stock" with "the aggregate value of those savings"
16 is precisely the method that I used to estimate the Section 7-204(c) allocation. Mr.
17 Kahan's FCC affidavit affirms and corroborates my methodology precisely. Moreover, it
18 is worth noting that conspicuously absent from Mr. Kahan's statement is any
19 differentiation between savings and revenue enhancements, a distinction upon which Mr.
20 Gebhardt placed so much importance.

21
22 Further, in responding to parties who criticized the likelihood of merger synergies, Dr.
23 Carlton, in his FCC Reply Affidavit, stated:

24
25 While the establishment of synergy estimates require [sic] significant elements of
26 judgment, this does not necessarily imply that estimates are unreasonable or

27 107. Kahan (SBC), FCC Reply Affidavit at ¶ 20. Emphasis supplied.

1 overstated. In this case, the credibility of SBC's estimates of synergies that can be
2 generated from the Ameritech transaction can be gauged by analyzing SBC's track
3 record in achieving the synergies claimed in its merger with PacTel. SBC's
4 experience from the PacTel transaction provides strong evidence that they provide
5 realistic estimates of savings.¹⁰⁸
6

7 The utter inconsistency of the Applicants' position on this issue is blatant and striking:
8 At the FCC, where the concern is with justifying the reasonableness of the transactions
9 by demonstrating the existence of substantive economic benefits, Mr. Kahan and Dr.
10 Carlton affirm the accuracy of the savings projections upon which the transaction was
11 based; here in Illinois, where the Applicants' concern is with minimizing their financial
12 exposure under Section 7-204(c), they seek to dismiss *the very same savings projections*
13 as speculative and uncertain. If these projections are good enough for the FCC and for
14 the Applicants' directors and shareholders, then they certainly are a valid basis for this
15 Commission to use in calculating the Section 7-204(c) allocation to ratepayers.
16

17 Fourth, and contrary to Mr. Gebhardt's assertions, my calculations used the Company's
18 own estimate of the percentage of Ameritech Illinois' intrastate operations that are
19 associated with noncompetitive services. If we used an outdated value it was because
20 Ameritech failed to provide parties with timely responses to the various requests

21 108. Carlton (SBC/Ameritech), FCC Reply Affidavit, at ¶ 95. By contrast, in the oral reply
22 testimony of James Kahan in the SBC/SNET merger case, before the Connecticut DPUC, Mr.
23 Kahan repeatedly emphasized the uncertain nature of merger synergies. The Applicants are
24 championing the concrete synergistic benefits to both the FCC and Wall Street in order to
25 justify the merger, while at the same time cautioning state commissions (that ultimately hold
26 the power to effect a change on the Applicants' rates and revenues) on the speculative nature
27 of those same synergy estimates. See *Joint Application of the SBC Communications Inc. and*
28 *Southern New England Telecommunications Corporation for a Change of Control*,
29 Connecticut DPUC Docket No. 98-02-20, Tr. at 1270-1278.

1 submitted to confirm numerous data, including these factors. As I specifically stated in
2 footnote 120 in my testimony,

3
4 To Mr. Gebhardt's factors, I added a factor that captures the portion of Ameritech
5 associated with noncompetitive services (i.e., Telecommunications and Directory
6 services), which is based on the segmented public market analysis valuation of
7 Ameritech Corporation prepared by Salomon Smith Barney, as reported in the
8 Amended Joint Proxy Statement, September 21, 1998, at 30-32. It is important to
9 note, however, that we assume this factor includes all noncompetitive services
10 independent of the price cap plan. If that is not the case, this factor should be
11 corrected.
12

13 On this point, I have noted previously that the Commission has now issued several
14 Orders initiating investigations of the Company's practice of reclassifying "non-
15 competitive" services as "competitive." Mr. Gebhardt's figures are presumably based
16 upon Illinois Bell's own "declarations" as to the "competitive" status of specific services,
17 "declarations" that the Commission is now reviewing. If the Commission determines that
18 any or all of these reclassifications were invalid, then the "noncompetitive" factor offered
19 by Mr. Gebhardt is also invalid, and would need to be increased.
20

21 Fifth, Mr. Gebhardt takes issue with my proposed 10-year amortization period but
22 provides no reason why. Mr. Gebhardt appears to be misunderstanding the point of this
23 recommendation, which is if anything quite conservative. Ameritech shareholders will be
24 receiving the *totality* of the present value of the merger synergies being allocated to them
25 almost immediately through the escalation in the market value of their holdings after the
26 Ameritech stock is converted into SBC shares at the agreed-upon transfer ratio. By
27 contrast, I have recommended that the ratepayer allocation be spread over ten years. In
28 the event that most or all of Illinois Bell's services were to actually confront real and

1 effective competition prior to this date, the marketplace would set prices, superseding the
2 explicit savings allocation. If the Applicants' assessment that all services will be
3 competitive within three years comes to pass (not because they "declare" it as such but
4 because real and effective price-constraining, sustainable competition actually develops),
5 then Illinois Bell will have been required to flow through only three years' worth of
6 merger savings in regulated rates. The ten-year amortization is designed to protect
7 ratepayers in the event that sufficient competition fails to develop as the Company claims
8 it will; if Mr. Gebhardt would prefer to allocate the totality of the Illinois share of merger
9 benefits to ratepayers immediately upon consummation of the transaction, I would
10 certainly have no objection.

11
12 Q. Do you agree with the proposal made by Staff witnesses Marshall and Yow relating to
13 the use of actual synergy benefits in calculating an amount to flow through to Illinois
14 ratepayers?

15
16 A. No, I do not. As described briefly by Ms. Marshall, and in more detail by Ms. Yow,
17 Staff recommends that the actual synergy benefits between the date of approval of the
18 merger and March 15, 2000 be calculated, and that an allocation of this amount be spread
19 equally across five customer groups at the time of the Alternative Regulation filing by
20 Illinois Bell in April, 2000.¹⁰⁹ The actual process of implementing the allocations
21 being recommended by Ms. Yow is of secondary importance, for the ultimate problems
22 lie in the limited window of time she would allow to gather data on the actual benefits of

23 109. Yow (Staff), Direct at 27-30.

1 the merger, as well as in the very limited scope of the specific synergy benefits that she
2 would include in the Section 7-204(c) allocation.

3
4 Assuming the merger is approved no earlier than June, 1999, under the plan recom-
5 mended by Ms. Yow the Commission would have a period of just eight and a half
6 months during which actual synergy benefits could be calculated. Given that, as the
7 Applicants admit and as is evident in their detailed financial workpapers, most synergy
8 benefits will not begin to arise until after 2000 (and what few benefits may arise by then
9 will surely be offset by the implementation costs associated with the merger), this abbrevi-
10 ated time frame is simply insufficient for determining the true effect that this merger
11 will have upon the new Company's costs. I understand that Ms. Yow recommends that
12 none of these implementation costs should be recovered by the Applicants, but this caveat
13 fails to correct for the gross understatement of synergy benefits that Ms. Yow's brief and
14 early data collection period will promote. Moreover, merely increasing the time period
15 over which actual synergy benefits are calculated will not help matters, since it will delay
16 the flow-through of benefits to ratepayers, and push the Applicants closer toward a period
17 when deregulation (although not necessarily competition) *may* actually occur, which
18 could have the effect of unhooking Illinois Bell from the regulatory leash held by the
19 Commission, thereby limiting the Commission's ability to secure the benefits rightfully
20 belonging to ratepayers. While this move toward deregulation *could* result in benefits to
21 ratepayers (through lower market prices for what are currently considered to be regulated
22 services), during the transition toward deregulation ratepayers would be denied their fair
23 share of the merger benefits, benefits that would not exist but for the years of ratepayer
24 support of the Illinois Bell network.

1 Further, the process described by Ms. Yow contemplates only those merger-related
2 benefits that are specifically allocated to Illinois Bell by the new SBC holding company.
3 As I have discussed above and in my direct testimony, the correct starting point in
4 determining the amount of synergy benefits to flow to Illinois ratepayers is the total
5 estimated savings and revenue increases that are currently inuring to shareholders of
6 Ameritech. Ms. Yow's proposal fails to capture the aggregate merger synergies that may
7 ultimately benefit other affiliates of SBC *and that would not have been possible but for*
8 *the merger with Ameritech.*
9

10 Q Mr. Gebhardt further argues that your proposal to implement an annual \$343-million
11 reduction in rates would be "devastating" for Ameritech because "Ameritech Illinois'
12 1997 operating income for its entire intrastate operations was only \$366 million on a
13 post-tax basis" which, according to Mr. Gebhardt, would leave Ameritech with only \$150
14 million in operating income. Please comment on Mr. Gebhardt's contention.
15

16 A. Mr. Gebhardt is making an inconsistent and unfair comparison between present, *pre-*
17 *merger* Illinois Bell earnings and the *post-merger* allocation of merger benefits to Illinois
18 Bell ratepayers. As I noted earlier, by his specific equating of "the premium paid to
19 Ameritech's shareholders when they exchange their stock for the new SBC stock" with
20 "the aggregate value of those savings," Mr. Kahan has affirmed and corroborated the
21 precise methodology that I used to calculate the Illinois Bell share of those savings.
22 Assuming that the post-merger SBC assigns to Illinois Bell its proportionate share of
23 merger savings, i.e., \$343-million annually on a pre-tax basis, there will be no diminution
24 in the Company's earnings relative to the present condition, except for the timing of

1 savings and credits. And I have adjusted for any differences in timing by calculating an
2 annual amortization using the same 9.5% discount rate that had been used by Mr.
3 Gebhardt.

4
5 If, on the other hand, the post-merger SBC assigns to Illinois Bell *less than its*
6 *proportionate share of the merger savings*, then Mr. Gebhardt's concern may be well-
7 taken. However, in that event, his argument will be with the manner in which
8 intracompany transfers are made within SBC, and not with the manner in which the
9 Section 7-204(c) allocation to Illinois ratepayers is accomplished. If SBC fails to
10 adequately compensate Illinois Bell for its use of, for example, Ameritech "best practices"
11 elsewhere in its region, or for SBC's ability to exploit monopoly relationships that Illinois
12 Bell has with major corporate accounts headquartered within Illinois to promote SBC's
13 out-of-region CLEC businesses, or for the transfer of Illinois Bell personnel and other
14 resources to nonregulated components within SBC, then it is entirely possible that, after
15 making the required allocation of merger savings to ratepayers, Illinois Bell will
16 experience a decrease in earnings. The Commission should address Mr. Gebhardt's
17 concerns by directing that Illinois Bell be fully and adequately compensated for any value
18 that it contributes to the post-merger SBC and that SBC, as a condition for approval of
19 the merger, assure the Commission that Illinois Bell will in fact receive its proportionate
20 share of merger benefits. The Commission should certainly not permit any diversion of
21 merger benefits away from Illinois Bell that SBC might choose to implement, to serve as
22 a basis for limiting the Section 7-204(c) allocation.

23

1 Q Dr. Selwyn, Mr. Gebhardt does not seem to understand your flow-through calculation and
2 allocation method. Can you please explain your calculation of the synergies attributable
3 to Illinois and your proposal to flow-through those synergies to ratepayers?
4

5 A Yes. As I explained in detail in my direct testimony (pages 83-92), I developed a
6 "composite" allocation factor of 8.77% to be applied to the total estimated Ameritech
7 synergy benefits of \$15.4-billion (using the "present value basis"). The composite
8 allocation factor reflects the percentage of Ameritech represented by telco operations, the
9 percentage of Ameritech telco operations represented by Illinois Bell, the percentage of
10 Illinois Bell telco operations that is jurisdictionally intrastate, the percentage of Illinois
11 Bell intrastate telco operations that is associated with regulated services, and the
12 percentage of Illinois Bell intrastate regulated telco operations that is associated with
13 noncompetitive services. This calculation results in a total allocation to Illinois Bell
14 intrastate noncompetitive services of \$1.4-billion, to be flowed through to Illinois Bell
15 ratepayers. This \$1.4-billion allocation should be flowed through ratably over a ten-
16 year period, amortized at a 9.5% discount rate and adjusted from an after-tax to a pre-tax
17 basis. Specifically, application of the 9.5% discount rate to the \$1.4-billion results in an
18 annual after-tax figure of \$216-million. When adjusted to a pre-tax basis, this results in a
19 \$343-million annual rate reduction.
20

21 As I explained on page 91 of my direct testimony, and as Mr. Gebhardt apparently fails
22 to understand, there are certain accounting adjustments that need to take place "... in
23 order to recognize the reduction in plant acquisition and operating costs, and the
24 allocation of certain costs to other components of the merged entity that result from the

1 merger." When all adjustments together with the rate reduction are considered, there
2 should be no net change in Illinois Bell's intrastate return on investment associated with
3 noncompetitive services.
4

5 **Conclusion**
6

7 Q. Dr. Selwyn, is there anything in the Applicants' rebuttal testimony that would cause you
8 to modify any of the specific analyses and recommendations that you have made to this
9 Commission regarding the proposed SBC takeover of Ameritech?
10

11 A. No, the Applicants' rebuttal testimony contains no new facts or arguments that were not
12 addressed fully in my direct testimony.
13

14 Q. Does this conclude your rebuttal testimony at this time?
15

16 A. Yes, it does.